

What we do is to look at where the good ideas are in Europe and then buy our convictions and avoid the rest

Oliver Russ, manager of the £195m ResolutionAsset Argonaut European Income fund, speaks about the benefits of being the only true equity income fund in the sector and his plans for 2007

Q Of the two on shore European funds managed by Argonaut Capital under the auspices of Resolution Asset Management, one is designed to produce alpha while the other aims for income. What is the distinction between the two funds?

Oliver Russ: The Resolution Argonaut European Alpha fund has an unconstrained portfolio that takes up to the best 55 ideas from wherever they happen to be in Europe. It is not constrained by benchmarks, indices or anything.

The European Income fund has a slightly different mandate. Whereas the Alpha fund has to maximise absolute returns, the Income fund is specifically designed to generate a certain level of income in excess of the MSCI index. At present, the index yields about 3.3 per cent and the fund yields about 4.1 per cent.

The genesis of the fund is quite interesting. We approached Resolution in 2005 and told them we were finding quite a number of very high yielding European equity ideas for the Alpha fund, but we simply could not include them all within that particular fund. We proposed setting up a fund dedicated solely to high income, as the strategy has worked very well in the UK for decades.

Their initial response was to be concerned as to why currently there were not any European income funds. To which we responded: "This is the reason we want to launch one."

Q: You have stated the fund is the only true equity income fund in the Europe ex UK sector. Why is this distinction important for potential investors?

OR: Most UK investors have UK income funds which have done very well for them over the last decade. But what they do not have a lot of is either European equity or European income funds. European income is a great way of diversifying your assets away from the UK, which is looking a little stretched. Every UK income fund owns Lloyds TSB, for example, because it has to. Put simply, there are not that many high-yielding UK shares any more.

But if you have the whole of Europe with 12 major markets to choose from, there may be one or two ideas from which you can build a good, diversified portfolio that you could not in the UK. You can actually get higher yields at lower risk than you can in the UK market.

Q: ResolutionAsset Argonaut Capital funds raised over £500m in funds under management last year. How much of that was invested in the European Income fund and what is an ultimate optimum fund size?

OR: We launched the income fund in December 2005 with £20m initial investment from Resolution and it is now £195m. It was their second biggest-selling proposition last year.

But there is a natural limit to the amount of money you can run in a highly-active strategy like this. So we find ourselves in a position where we turn down large, but lower margin mandates because there is a finite capacity. We are not sure where that is, but I would expect we may soon reach that level.

The Income fund can handle more money because it has a much lower turnover. Basically, if nothing goes wrong with the story, you can hold these

£20 million
Seed funding just over a year ago which has since grown to £195m

stocks until they drop. But even the Income fund will eventually have a natural limit.

Q: But despite that success, there is still concern about whether investors are that keen to invest in Europe. Why, for example, did Resolution pull the launch of its European Equity investment trust, which was to be run by yourself and Barry Norris?

OR: The reason was that most people did not see the advantage of having it in a trust format when they could already buy the open-ended fund. You have all the problems of an investment trust – as well as the advantages. For example, it could go to a discount and there could be liquidity problems. Most people said they preferred to invest in a unit trust.

Additionally, it was slightly more tax-efficient to do it in an open-ended format. In an investment trust, you are not allowed to take anything out of capital, but in an income fund, obviously, all the charges come out of capital not the income. So you would have ended up with a lower yield on the investment trust than you would have had for the unit trust, which removes the point of doing it.

Q: Was there any question that IFAs and the general public were actually concerned about the prospects for Europe?

OR: No, Europe's prospects are very bright this year. It is in a slightly different cycle to the UK and US. It lags behind slightly so I see very good gross domestic product growth out in central Europe this year, which has not been a feature that has been noticeable over the last few years. This year you will see the US slowing quite dramatically, and

CV

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2005 Partner, Argonaut Capital Partners
2004 Fund manager for Neptune Investment Management
2002 Partner and fund manager for IIM
1998 Trainee fund manager for Orbitex Investments
1992 Classics at Christchurch Oxford

while the UK is proving remarkably persistent in its growth at present, there are one or two problems bubbling up that will not be an issue in Europe. These include the massively overvalued housing market and consumer debt, which while they do exist in parts of Europe, they are not a systematic problem yet.

Any considerations that investors may have had about not investing in the closed-ended structure were simply to do with the structure of the investment trust itself – not because they felt that Europe did not offer some interesting investment opportunities. We have had sustained interest in the open-ended funds throughout last year and this year as well.

Q: There has been much talk of how European private equity deals are driving European growth – KKR and Goldman Sachs have recently bought a slice of German gasses firm Linde, Philips Electronics has sold the majority of its semiconductor division for £4.87bn and French media giant Vivendi is still up for grabs. How does this translate into investment opportunities for the fund?

OR: It is where the Income fund naturally focuses, as we tend to look for high dividend payers – companies with high free cash flow because these are private equity takeover targets. At the moment, this has led both funds towards the telcos sector. Everybody has been frantically bidding for utilities all over Europe on the basis that they will be able to securitise the cash flows and make a fortune. What has been neglected until a few months ago is the telcos sector, which exhibits very similar characteristics but has less volatility. These are ideal candidates for securitisation and refinancing with debt rather than equity.

What we will see this year in telcos is a mega-deal – upwards of €30bn – that takes out a major telco. One of the companies that might be a target is TeliaSonera, a Swedish telco that has done tremendously well since the Swedish elections.

Q: The boutique is jointly run by yourself and Barry Norris. How do you work as a team? Do you have different areas in which you specialise? And how does that relate to your relationship with Resolution?

OR: It is useful to be part of a small team as you can bounce ideas across the desk whereas most places are tied up in meetings and committees. We can get an idea in the portfolio as quick as we like.

Barry runs the Alpha funds and I manage the income funds – but we both work to generate ideas across strategies. It is very important for there to be a single captain for each fund.

As far as the partnership is concerned, all decisions are reached mutually. On the board of Argonaut we have Barry and myself and then two representatives from Resolution, but we have total responsibility for the fund management. They provide all the sales and marketing and support services.

Q: Leaving you as a boutique, able to be nimble and limber when it comes to investing?

OR: That is the idea and it does seem to work quite well in practice. If you look at the standard boutique, they tend to be quite resource constrained and you do find yourself getting tangled up in admin matters that you would rather not be doing. The great thing about Resolution is that they have plenty of admin staff and a huge amount of experience in areas such as compliance. This means we can offload all of this onto them and concentrate on managing the money.

Q: It also means you can run quite high conviction funds. The Income fund, for example, does seem very concentrated with between 30 and 50 firms within the portfolio. Why are there so few holdings in the portfolio?

OR: We do not see the point of using an index to allocate capital. If you look at the UK, the index is dominated by four big names and if you own a tracker fund you are taking on an enormous amount of risk for no real benefit. What we do is to look at where the good ideas are in Europe and then buy our convictions and avoid the rest.

Q: You mentioned telcos was one particular sector in which you were invested, but which other themes or sectors are you monitoring for potential investment returns in 2007 and 2008?

OR: It is clearly going to be a more difficult year than the previous three years, as the market has moved quite a long way. We are now looking at those companies with decent free cash flows, high yields and stable, high quality companies that are not on too demanding a valuation. This has led us first to telcos, but the other greatly undervalued area at the moment is banks, which is looking pretty cheap. The Income fund is also looking to a large degree at property companies in Europe as well.

Q: So are you moving the fund to a more defensive position?

OR: Yes, we are thinking with a much more defensive mindset this year, trying to protect our gains. The Alpha fund is up by 75 per cent in the 18 months since launch, which is a huge amount to get out of the market and you have to wonder at what rate that will be continued into the future. Realistically, we have to prepare ourselves for a period of volatility at least in the first half of the year.

