

look beyond our shores

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Oliver Russ explains why geographic diversity and healthy dividend payments are the key to income-seeking success.

UK-based investors seeking an investment that provides them with an income stream and the potential for capital growth have historically favoured UK equity income funds. At Argonaut, we believe this home bias can result in an overly constrained investment style, and suggest that income-seeking investors would do well to look beyond these shores, to continental Europe.

In the UK, nearly 60% of the FTSE® 100's dividend yield is paid out by the top ten companies by market capitalisation. Even this top ten is not particularly diversified, with oil majors BP and Shell accounting for nearly 25% of the index's yield, and pharmaceutical giants AstraZeneca and GlaxoSmithKline accounting for 10%. This concentration means that UK equity income fund managers will frequently be required to own some of these stocks, whether or not they like the company, because not to own them would add an unacceptable amount of risk relative to the benchmark.

In continental Europe, no such restrictions exist, with less than a third of the index's dividend yield coming from its top ten companies. The market for yielding companies as a whole is deeper and wider, with a greater range of sectors represented. Many of these companies are world-leading multinationals, with

brands that many British consumers would recognise, such as H&M, Nestle, and Santander – now a major feature of the UK high street banking scene. Management of European corporations has proven adept at building cash-rich, low-debt businesses, and European markets are now modernised and shareholder focused, meaning healthy dividend payments are possible. European markets are trading at the lower end of their valuation range, and recently as many as 60 companies were yielding more on their equity than their corporate bonds. This is a highly unusual situation, and surely a sign that higher yielding equity is cheap.

the value of income investing

Looking at the long-term performance of the stock market, a strategy based on investing in dividend stocks has outperformed the broader market and had lower volatility. It is also worth noting that in the last 20 years dividends represent almost half of global equity total returns, as measured by the MSCI World Index.

Investors who are familiar with the long-term attractions of a value investment style will not be surprised by the importance of dividends. A strategy

focused on high-yielding stocks is of course a type of value approach. Indeed, since the launch of the MSCI Europe High Dividend Yield Index, it has offered lower risk and higher returns than the pure MSCI Europe Value Index.

A progressive dividend policy can provide an indication of the quality of a company. Regular returns of cash to shareholders can demonstrate a sound, disciplined managerial approach. High dividends also often indicate a high level of free cashflow, which allows a company to pursue opportunities that enhance shareholder value as well as distributing cash through dividends. While 'creative' accounting can disguise balance sheet problems, cash is a hard-and-fast measure of how well a company is doing, not based on market sentiment or estimates of sales and growth.

Companies able to generate regular dividends and consistently high cashflow are, by nature, likely to be well established, larger and able to withstand a variety of economic conditions. This means that dividend-paying companies tend to have defensive qualities. The largest equity income sectors in continental Europe include the oil and gas, telecommunications and utility sectors, all of which offer goods or services that continue to be in demand, even during tough times. ●●

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Argonaut's approach to high yield investing

A company's dividends are at the core of equity investment. A company can be viewed as the present value of all its future dividend payments, and many investors therefore use a dividend discount model to establish company valuations. The market rewards companies for delivering earnings growth, but dividends are an excellent proxy for earnings. Argonaut ideally seeks companies that are going to have a growing dividend stream into perpetuity, which should be a natural hedge against inflation. Unlike high yield bonds, for example, there is therefore scope to grow the dividend over time.

The Ignis Argonaut European Income Fund was launched in 2005 as the first fund of its kind invested purely in high yielding continental stocks for UK investors. It offers a relatively concentrated portfolio, which is actively

managed to provide regular income and the potential for capital growth. Since launch, the fund has been able to consistently generate higher levels of income than the majority of its counterparts who are limited to investing solely in the UK. Expectations for 2010 suggest this will continue to be the case in the months ahead.

combating the currency risk – introducing a new fund

In our discussions with investors in the existing fund, which is not hedged, but denominated in euros, the issue of potential currency volatility was raised. With the euro set to face a challenging 2010, investors may be forgiven for feeling nervous about exchanging their sterling for assets denominated in euros.

For those that are nervous, our recently launched Ignis Argonaut European

Enhanced Income Fund has two key differences to the original fund that should help reassure concerned investors.

First, the yield will be enhanced by a simple call overlay strategy. This is a low-risk mechanism that sacrifices upside potential in strongly rising markets to pay an enhanced stream of income to its investors; we anticipate that the fund will yield 7% in its first year*. Secondly, currency exposure will be hedged to sterling. Our hedging policy** will substantially reduce the currency risk investors face. Both funds will invest in large, well managed companies in strong competitive positions, showing the potential for dividend growth which is likely to include the likes of Danone, Santander and H&M, among many others.

The Ignis Argonaut European Income Fund is available now through Skandia Investment Solutions and Skandia's Life & Pensions fund ranges. The Ignis Argonaut European Enhanced Income Fund launched through Skandia Investment Solutions on 13 May 2010.

Oliver Russ is Fund Manager and Partner at Argonaut Capital Partners.

*The fund is expected to deliver 7% in its first 12 months, and then 5-9% in subsequent years depending on market conditions.

**The currency hedging strategy aims to hedge 95% of all foreign currency exposure. In a strong euro environment, the fund might underperform the peer group due to this hedging policy.

Past performance is not a guide to future performance. The opinions expressed here represent the views of the fund manager at the time of preparation and should not be interpreted as investment advice.

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