playing to its strengths

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Richard Pease examines the prospects for his newly launched Henderson European Special Situations Fund.

The credit crisis had a profound impact on European equity markets; indiscriminate equity market falls across Europe during 2008 and the first quarter of 2009 led to some highly attractive valuations among quality companies. We saw this as an ideal opportunity to exploit the expected uptrend and take advantage of low valuations and relatively healthy income, by launching the Henderson European Special Situations Fund.

The fund was designed to play to particular strengths, utilising a successful stock-driven investment process that has delivered outperformance over two decades. I applied this method of investing first at Jupiter Asset Management, where I was responsible for launching and managing the top-performing Jupiter European Fund for more than 11 years. In 1999, I launched the Jupiter European Special Situations Fund, which again was the best performing fund in its class during my time as manager.* In 2001 I joined New Star to take charge of their European Growth Fund, which I still manage today (now the Henderson European Growth Fund).

keeping it in the family

The name may have changed but the stock selection process remains the same. As well as looking to invest in business models that have long-term pricing power and a high level of recurring income, we favour companies where management have personally invested a significant amount of money. Many of the fund's larger positions are dominated by family or management shareholdings. Good examples include the positions in two lift companies, Kone and Schindler, together with stocks such as Fuchs Petroleum, one of the world's largest independent lubrication businesses and Coca Cola Hellenic Bottling. All these stocks have a high degree of recurring sales, strong balance sheets, good returns on capital and, perhaps not surprisingly, the families involved have chosen to remain the dominant shareholder.

Another characteristic that features heavily within our stocklist is businesses that do not need heavy capital expenditure to grow. This tends to result in a bias towards service-oriented companies as opposed to more capex-hungry industrials or hotel companies. We believe that being 'capex-lite' should result in the generation of substantial free cashflow. This, in turn, allows a business to both self fund growth and seek appropriate acquisitions, all of which should help to enhance shareholders' returns.

A special situations fund does not necessarily have to chase 'high-risk' stocks. Instead the emphasis should be on identifying attractively valued companies with robust balance sheets, quality management, strong cashflows and pricing power. Those companies that find themselves in the recovery stage may be considered, but will only be invested in where there is a clear business strategy offering a route to success. We look to invest in companies of all sizes, but with a bias towards medium-sized companies where we can not only take full advantage of smaller, less liquid situations that would be

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*Source Lipper, gross of income, net of fees basis 26 February 1999 to 30 June 2001.

The performance of the Skandia fund will not mirror the performance of the underlying fund because of Skandia fund charges, taxation adjustments (if appropriate) and the Skandia investment process.

less appropriate for a large fund, but where we expect to be able to capture the most undervalued growth opportunities. It is important to stress that we plan to maintain this mid-cap bias and have taken steps to ensure that the fund does not become a victim of its own success.

a bright future in an uncertain climate

A full six months after the launch of the Henderson European Special Situations Fund and the first half-term report is a broadly positive one. The fund has made solid progress during turbulent trading conditions when European sovereign debt fears have continued to weigh heavily on markets. Against such an uncertain economic backdrop, the start we have made has been encouraging. We believe the fund can continue to generate good long-term returns. Investors may be reassured to know that this assertion is reinforced by personal interest, as I like to put my money where my mouth is. I was a significant investor in the Henderson Special Situations Fund from the outset and have made further major investments recently, along with other family members. This approach is also consistent with our investment process, with our preference for management who can demonstrate a significant investment in their business. However, I very much recognise the family Christmas at the year end may be a tricky occasion if I fail to keep my investor base happy.

Richard Pease manages the Henderson European Special Situations and Henderson European Growth Funds.

too big for your boots:
when outperformance can be a problem

A successful fund manager, rather like a jockey, can find himself subject to a handicapping system. Should a fund outperform significantly, it attracts funds until such a time that size restricts its flexibility. This is particularly the case if a fund has a large element of smaller or mid-cap companies which are less liquid. The manager is presented with an unattractive choice, namely should he move into larger, more liquid stocks that may not offer the same upside potential, or should he stick to his knitting and take increasingly larger percentages of a company and risk being unable to sell a position should the need arise?

I have in the past witnessed such a dilemma first hand, both at Jupiter and, more recently, New Star. Outperformance led to dramatic growth in the main London and Dublin-based European funds, followed by equally dramatic outflows in 2008 when the market fell sharply. Unlike a number of mid-cap biased funds, all redemptions were handled without any major issues due to our strong liquidity disciplines. It was not feasible, however, to launch a new fund until both market sentiment had improved and the acquisition of New Star by Henderson gave investors the much-needed reassurance to commit new money.

how we avoid this problem

In order to try and avoid the problems associated with a fund outgrowing its optimum size, we decided before launch that the Henderson European Special Situations Fund would seek to restrict fund inflows on reaching £500 million. We intend that growth above this level will be principally organic and this will help to minimise the size risks and constraints mentioned above.

The Henderson European Special Situations Fund is available through the Skandia Investment Solutions platform and Skandia's Life & Pensions fund ranges.