WAVERTON
INVESTMENT MANAGEMENT

An article was published by Trustnet on 26th February listing the
"European funds topping their sector on (just about) every metric"

CLICK HERE TO READ THE TRUSTNET ARTICLE

It was gratifying to see the Waverton European Dividend Growth independently recognised as one of the most consistent performers over the last 5 years. Despite being an income fund this article pitches Charles Glasse and Chris Garsten against the many great names that make up the entire Europe-ex UK peer group, including the Waverton European Capital Growth Fund which also features in the top 10.

The purpose of this thought piece is not to draw attention to past performance. Instead let us explore the positioning of the European Dividend Growth Fund and why, in the context of the current backdrop, the team believe they have the tools to navigate the challenges facing a *very* out of favour European equity market.

Positioning: a collection of pearls

Readers may want to follow this link for a reminder of the five key attributes the fund managers seek in a company.

Charles and Chris have always constructed their portfolios endeavouring to select long-term winners according to their five key attributes and holding them through the cycle, with an emphasis on owning companies where management's interest are aligned with delivering returns for shareholders. They define these companies as either Margin Improvers or Steady Growers.

Margin Improvers - companies that are generally in the early stages of transformation and have not yet achieved the attributes we look for. Thus they could be considered "dirty pearls" – businesses with significant potential value not yet recognised by the market.

Steady Growers - businesses that are starting to show themselves as pearls, but still haven't gained full size or lustre. That is, margins, return on capital and cash flow, etc. are approaching their potential and should be sustainable as the companies continue to grow and managements work to maximise earnings / returns to shareholders.

By sticking to their five key attributes and remaining disciplined on valuation, the managers construct a balanced portfolio consisting of Margin Improvers and Steady Growers at various stages of their development that can generate positive risk adjusted returns through the cycle.

This discipline has generally resulted in avoiding structural underperformers. The managers displayed this during the most recent sell off in Q4 2018 by not owning a sector (Financials) which failed to meet their criteria. This helped the relative performance at that time and both funds remain underweight the sector (banks in particular).

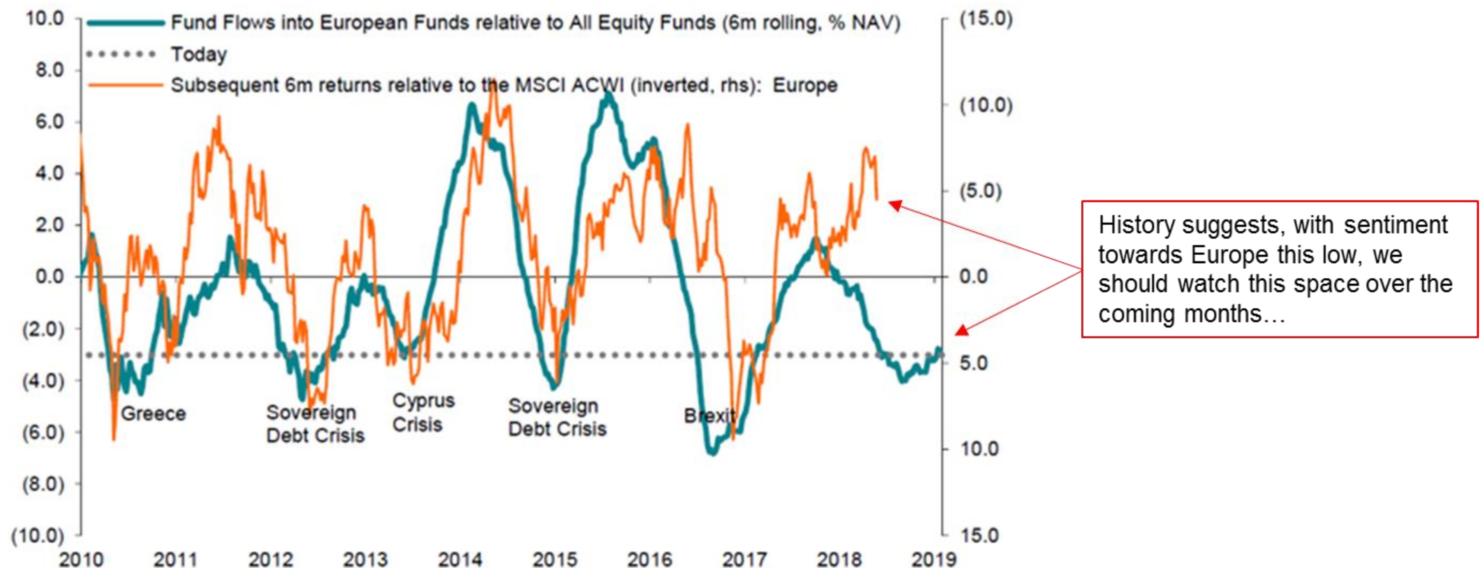
Which brings us to where we are now….

As a consequence of following their process, the team currently have around two thirds of the portfolio invested in companies that are regarded as non-cyclical. The managers are confident these companies can continue to compound earnings growth, even in a low growth environment. The great potential source of alpha is the third of the portfolio invested in "dirtier pearls", as shown here in the portfolio. These businesses could be perceived, on the face of it, as more cyclical or economically sensitive, and some perhaps even seen as in turmoil. However, these shares with potentially good underlying operations could materially benefit from any number of factors - including management turnaround, an uptick in their respective business cycles, such as shipping and mining, or indeed any decrease in trade war fears.

Macro backdrop: Why draw attention to a top performing Fund in a poor performing region?

One of the perennial stumbling blocks for international investors looking at Europe is the mixed political and macro-economic outlook. As stock pickers we do not dispute this. However, history has shown that Europe has a habit of surprising on the upside just when sentiment is at its worst.

The chart below from BNP Exane tracks fund flows out of Europe as a percentage of NAV (blue line) vs European subsequent 6-month returns relative to the MSCI ACWI index (orange line inverted):



Source: Exane. As at 31st December 2018

The second debate amongst investors is whether Europe's persistent, and currently pronounced, discount to the US represents an attractive entry point. Again, as stock pickers, we do not point to the relative valuations in isolation as a catalyst to buy. To us the higher US rating emphasizes the great potential for higher shareholder returns in Europe. We believe that in just one third of European companies are management interests aligned with shareholders. These are the companies that are capable of delivering higher returns to investors. Indeed, some of the European Dividend Growth Funds' holdings have North American management who are committed to returning excess cash/capital to their investors via dividends and share buybacks. On this basis we would argue the current portfolio looks very attractively valued, especially for those looking to invest for total returns through the cycle.

Finally, it is worth reiterating that over the 18-year period that Charles Glasse and Chris Garsten have been investing together there has rarely been an attractive time to buy Europe on a top down basis. However, their style agnostic approach to selecting European companies that are capable of generating wealth for shareholders has consistently delivered outperformance over the index in every 10 year rolling period since the European Dividend Growth Fund's launch in 2005.

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