EUROPEAN EQUITIES

Making the most of your European active equity portfolio

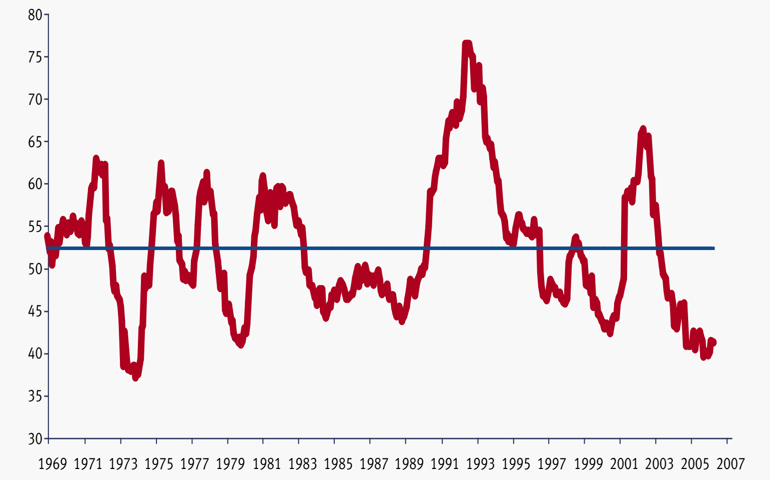
Nick Phillips of GSAM outlines options for investors considering actively managed European equities

There are two key questions for investors looking to select an actively managed European equity portfolio. Firstly, should they retain their current levels of exposure to the market? Secondly, what should they look for in their manager? On the first question, we believe the fundamentals of the European market remain historically strong and offer glimpses of good potential returns to come. Examples include:

1. Strong levels of cash generation
European equity free cash flow – which is the cash flow that can be either invested back into the business, or used for acquisitions, or returned to shareholders via dividends – is at historically high levels, with €212bn generated in 2006. This means that there is a strong possibility that investors will see good levels of income and corporates will continue to grow off the back of this investment. Furthermore, the dividend payout ratio, on a trailing basis, has now reached a 30-year low (see figure one). This suggests a high potential upside to the absolute level of dividends.

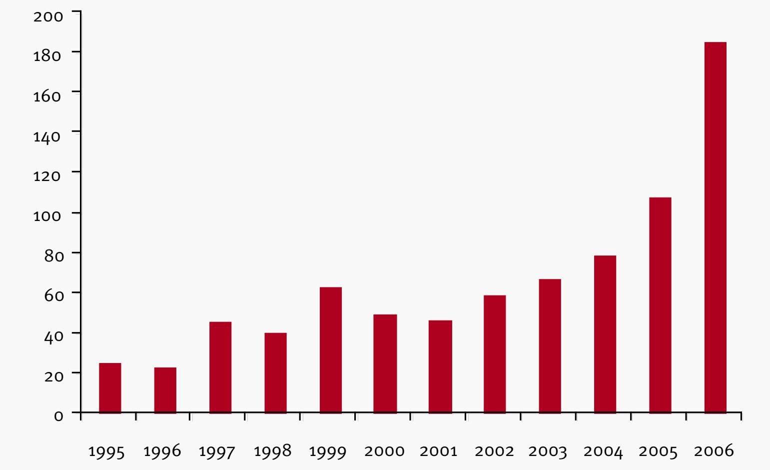
2. Insulation against slowdown
When we examine the constituents of the MSCI Europe, we continue to see positive indicators that Europe is better insulated against a slowdown in US growth than it has been in the past. For example, as demand for goods in Eastern Europe and other rapidly developing countries continues to grow, European countries become less reliant on exports to the US. Furthermore, European companies continue to restructure and streamline their business models to offer convincing returns for shareholders. The current boom in private equity is testament to this continuing search for greater efficiency (see figure two).

Figure one: MSCI trailing payout ratio



Source: UBS, Mar 07

Figure two: European private equity activity (€bn)



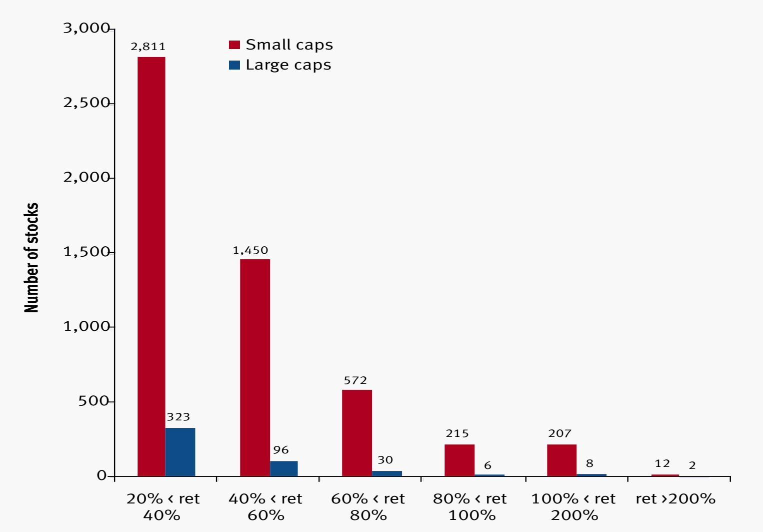
Source: UBS, Mar 07

3. Opportunities to hunt great small cap opportunities research from Citigroup demonstrates that there are currently fewer than seven sell-side analysts covering the average European small cap stock in comparison to an average of 19 for each large cap stock. In addition, there are greater return dispersions within small cap stocks (see figure three). This creates a fantastic hunting ground for ideas that not everyone has found, that skilled active managers can incorporate into their portfolio with the aim of outperforming the benchmark.

Navigating the European equity fund universe

The world of European equity funds

Figure three: greater return dispersion within European small cap and European large cap



Source: Citigroup, Feb 07

is increasingly diverse and offers a bewildering array of approaches. How should one best navigate this and find the most suitable fund? By not forgetting the basics. A solid starting point is to define a risk budget. Once determined, you will find a narrower and more manageable universe. Your first question may be whether you want to opt for passive exposure to the market, and accordingly pay lower fees. If you are looking for an active manager instead, how can they add value in today's markets?

What portfolio should I look for?
Some active managers add value by implementing high conviction ideas. For the investor, this means finding a manager who thoroughly knows the stocks in the portfolio, the stories behind them and the 'right' price for each stock. A portfolio of around 40-60 ideas allows for diversification with a sufficient degree of focus by utilising the manager's best research ideas.

But what about the benchmark?
What the investor is ultimately seeking is return within a risk managed framework. The popularity of the concept of absolute return has taught us that orienting a portfolio around a benchmark is not the only way of providing a risk managed portfolio. While a portfolio which doesn't hold everything in the index may appear higher risk, by freeing managers to pick stocks both inside and outside an index, you actually allow them to concentrate the risk in areas they feel will be compensated and avoid sources of risk that are ultimately unlikely to be sources of return. The result – a focus on ideas with the strongest potential from the broadest possible investment universe.

The hunting grounds
A less constrained approach may encourage genuinely passionate commitment to original, robust and well-researched investment ideas. Managers should thus be allowed to search for ideas across all market capitalisations. Often portfolios will have a large cap bias because they make close reference to their benchmark but, if a smaller company has better growth prospects and a stronger risk reward profile then it makes sense to give more weight to this small cap. In the same way, stock ideas can come from both the developed and developing markets. For example, a European equity manager may find stronger fundamentals displayed in stocks from emerging Europe that are not listed on the MSCI Europe and again it makes sense to allow their inclusion.

But what about diversification?
You could take this concept further and invest in a concentrated fund. These funds, which often consist of as little as 20 stocks, may seem extremely high risk and fly in the face of the diversification mantra which advisors strongly advocate. However, recent research into modern portfolio theory shows that portfolios of just 20 stocks yield the majority of the diversification benefits. Ultimately, it is a question of the investor's risk objectives: due to the greater degree of concentration, such high conviction funds may experience higher levels of volatility. But with skilful stock selection and an in-depth knowledge of holdings, a concentrated fund typically offers higher return potential over a longer period of time to compensate for the additional volatility. Accordingly, such funds can certainly have a place within a diversified total portfolio.

Manager skill over beta
The key concept of active management is for managers to pick stocks that they believe are undervalued. By giving managers all the tools available to aid that search, your portfolio potentially benefits from 'alpha' - aka manager skill - rather than purely 'beta'- aka market performance. When selecting an active manager, you should seek one with an entrepreneurial approach and a strong, consistent investment philosophy. In this way, you are likely to gain the best value from your active management fees.

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