SHINING A LIGHT ON……
BLACKROCK CONTINENTIAL EUROPEAN INCOME FUND

At a glance

Since Draghi's 'do whatever it takes' speech in 2012 the markets have become less worried about the collapse of the Euro and peripheral economies. There is a greater confidence around political stability in Europe.

However, investors continue to be wary of Europe which is reflected in negative inflows over the last five years. Towards the end of 2013 the outflows reduced and although still negative in aggregate it continues to narrow. As a consequence we are seeing more European fund managers on the road explaining why now is the time to invest.

We have recently met growth fund managers specialising in Europe but failed to find anything which stands out. However, after meeting the manager of the Schroders European Alpha Income Fund it highlighted that funds which can combine growth and sustainable growing dividends can significantly outperform pure growth plays.

Income not only helps provide downside protection but is also an important of the overall return. With greater volatility in the market these funds can form an important of an individual's portfolio if they combine growth with income.

We believe that the Schroders European Alpha Income Fund is a hidden gem however it does carry risks especially around calling the cycle and for some investors this may not appeal. We recently met the team behind the BlackRock European Continental European Income Fund. This fund may act either as an alternative option or a counter balance to Schroders. The performance is strong, it is a concentrated portfolio of currently 42 stocks and the top ten stocks make up 33% of the fund showing strong conviction traits although no one stock dominates.

Who are the team behind the fund?

There is stability behind the fund. The co-managers have been at the helm since 2006 when they joined BlackRock as part of the merger with Merrill Lynch Investment Managers (MLIM). Andreas Zoellinger is Co-Portfolio Manager for the BlackRock Continental European Income Fund, BGF Euro Markets Fund and the BGF European Equity Income Fund. He joined MLIM in 2001.

Alice Gaskell manages / co-manages the BIEF Continental European Fund, the BGF Euro Markets Fund, BGF European Equity Income Fund, BlackRock Continental European Income Fund as well as various Eurozone and Europe ex UK Portfolios. She joined MLIM in 1994.

The team have a plethora of awards and have a proven successful partnership.

What is the story behind the investment?

Some commentators argue that the US has had a strong run and there is not much more that can be gained from this market whereas the opposite is true for Europe. Although the European market was one of the strongest in 2013 much of it was through re-rating rather than growth.

The lead indicators (PMI and Consumer Confidence) indicate that this growth can come through in 2014 (although the economies are very fragile). The Q1 and Q2 corporate earnings news will be a crucial to how 2014 will behave.

Additionally companies in Europe are sitting on over €1 trillion on balance sheets. As companies feel more confident on the outlook the markets would expect this money to be put to use. This could be through M&A activity, buy-backs and special dividends.

If the news is positive the belief is that the second half of the year could be strong for European equities.

Fund highlights?

The fund focuses on large to mega cap companies and there is some crossover in holdings with other European Funds. For example the two largest holdings are Unilever and Roche.

The fund is different to pure growth orientated funds and is best summed up as capturing steady growth and low risk cash returns from high quality companies. Although this is an income fund there is no minimum yield requirement, they will search out companies which can grow dividends. An example would be Kona which since investment grew dividends by 18%, the stock has now been sold.

It is a stock pickers fund with a concentrated portfolio and does consider the wider macro picture. If the macro picture is poor then they will not invest. An example would be Nokia Tyres who have a large exposure to Russia and with the crisis they prefer not to hold despite the good dynamics of the business.

This is not the first time in 2011 they had no exposure to financials, in 2013 they started to add exposure to the fund but through carefully picked companies like Swiss Re.

In the discussion we had there is comfort both in the team and style but also it raises an important point that as markets move to more normalised returns then adding growing dividends to growth is a mechanism to generate strong returns without taking additional risk. It can also protect in the downside as the dividend should always be paid and therefore if growth is negative then the dividend will reduce the impact.

Therefore this style may act as a good balance to a pure growth fund or even the more punchy Schroder Fund.

They are looking for stocks offering a yield with secure dividend potential, and these will be quality and undervalued stocks. All of this is similar to any fund manager you listen to and everyone will say they are different. However, although there are examples of stocks you would expect the fund to hold there are also of lesser known stocks and this points to a more actively managed fund that doesn’t necessarily follow the crowd and is prepared to make decisions which might be contrary to others.

We discussed four examples of stocks:

1. Dividend Growth – Novo Nordisk currently paying dividends of 1.5% has delivered stable dividends and these are expected to grow in line with long-term performance

2. Undervalued Domestic – Atlantia currently paying 4.1% dividend but expecting the company the company to grow by 5% in the near term
3. Excess Capital – Swiss Re paying a dividend of 4.8%. Financials were added into the portfolio in 2013. This stock offers a sustainable dividend plus active capital management
4. Undervalued defensives – unibail-rodamco pays a dividend of 4.5% and this dividend is growing

In summary the perception of income funds is that they are dull with little growth potential which means investors sacrifice income for growth and therefore lose out in terms of market growth. The BlackRock Fund will deliver sustainable dividend income but with the companies it invests in it also provides growth. The two elements can therefore provide a good growth element for any investor but also downside protection.

Fund performance

The table below shows performance since launch (6 May 2011) and going into 2014:

	2011	2012	2013	2014	Since launch
BlackRock Continental European Income Fund	-13.54%	18.76%	30.52%	4.81%	40.46%
iShares MSCI Europe Ex UK	-23.33%	14.00%	21.74%	3.13%	9.74%

You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. The total return reflects performance without sales charges or the effects of taxation, but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted would be reduced.

Conclusion

The fund should act as good fund in its own right for investors investing in Europe or as a balance to a pure growth fund. It does have some stocks which you would expect to see in a European Fund but the managers are active taking into account the macro picture and are prepared to make investment calls which differ from the market.