

**GLOBAL EQUITY INCOME** Chief investment officer at Legg Mason's Global Currents Investment Management, Paul Ehrlichman is looking to provide investors with income, but not at the expense of capital appreciation

# A contrarian outlook for global success



Global growth: investors must maintain a high level of sector diversification



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Paul Ehrlichman is happy to be known as a contrarian investor. As chief investment officer at Global Currents Investment Management, part of Legg Mason, he has recently overseen the launch of the Legg Mason Global Equity Income fund. Sitting as part of the firm's UK ICVC fund family, the vehicle's remit is to provide investors with income – but not at the expense of capital appreciation. It is in this differentiating factor, Mr Ehrlichman explains, that being contrarian allows the manager to provide both sides of the equation.

“There are two ways to find income: one is to find companies that are paying a currently high yield and the other one is to find those firms whose stock is down 50 per cent, but the company still has a great capacity to pay the dividends. This is where we have a bit more of a contrarian slant,” he adds. “Not that we sacrifice on quality, but we buy companies that were paying 3 per cent yields and are now paying 6 per cent because they see no reason to cut the dividend, but global worries about that particular sector or country have hit the stock.”

But just because the company may be suffering in the global environment, valuations are still key to the manager's decision whether to hold the stock in the portfolio. “We are still valuation driven,” Mr Ehrlichman explains. “We are trying not to be a bond substitute. Many income funds can sacrifice a lot of upside in the equity markets going for income, but we try to balance that out and not have a large upside sacrifice. If, in the next five to 10 years, the markets continue to rise we want to participate in that fully and do even better from a capital appreciation standpoint.”

Key to achieving this is being able to invest on a global basis. UK companies now only account for 15 of the world 100 top-yielding stocks. Not only are these global companies providing attractive dividend-paying alternatives to UK companies, but they are also demonstrating significantly higher levels of dividend growth.

“We have diversified sources of income not only by sector and country,” Mr Ehrlichman says, “but we diversify by size of company. We are – and always have been – an all-cap manager.”

What generally happens is investors look purely at the top 20 companies in any one sector or country, he continues, but there remain many other opportunities throughout the cap scale. He cites the example of legendary value investor Warren Buffet, currently travelling around Europe looking at small caps. “He's not looking at large-cap Europe. He's not going to buy Nestlé,” he adds, “but there are lots of wonderfully run small companies that offer both capital appreciation and earnings growth potential.”

Through further diversifying the fund down the cap scale, Mr Ehrlichman says he is increasing his opportunity set. “We could not be properly diversified in terms of both countries and sectors if we didn't go down to the small and mid-cap names.”

## The usual suspects

Half the portfolio is still held in what he describes as “the usual suspects” – Unilever and BP, for example. “We hold the big-cap names that you would expect,” he continues, “but we can diversify the other half of the portfolio into Asia and Japan and some of the lesser-known emerging market names and small and mid caps that are excellent companies but at a stage in their growth where their shareholders are still extremely interested in income.”

Globalisation now means that many companies operate beyond their national borders, he adds, and investors need to ensure they do not get trapped in following the herd. It is an important differentiation of the fund, Mr Ehrlichman explains.

“We are trying to diversify from a sector standpoint. It is important investors don't just get caught in the traditional sectors, such as utilities, telecoms, financials and pharmaceutical, which may have declined and might bounce back, but they should not just overweight their holdings into those sectors. It is important to diversify into basic materials, transport and consumer discretionary and staples.

“Investors must maintain a high level of sector

diversification and diversify their income sources from a sector and a macro standpoint. If financials continue to have a hard time then it means the portfolio is not completely dependent on that.”

## Avoiding the traps

Other traps Mr Ehrlichman warns investors to avoid are what he calls “thematic extremes” – such as the supercycle boom.

“Value managers are in two camps,” he says, “either capitulating into the supercycle boom or being emotional and moving to hunker down and become negative on everything. Investors need to know not to get caught in these emotional extremes but have a diversified portfolio that does well as the global economy continues to expand.”

In his attempt to put this policy into place, Mr Ehrlichman has started to move – again on a contrarian basis – into Japan. Earnings growth remains strong in Europe, but is likely to be affected by the global economic slowdown. Japan, however unusual it might seem to go in search of yield, is a country “awash with cash. The companies are overcapitalised and underleveraged, and we can find many sensible, global leaders in their sector that are increasing their dividends by 30-50 per cent a year.”

Japanese Reits look attractive, he continues, as do certain pharmaceutical companies. “Reits have been crushed and are down dramatically,” he explains. “But there are a number of them that are very underleveraged with excellent balance sheets and very low loan-to-value ratios. They do not need the capital markets and the rents are rising; construction is not booming but it is falling so they're also not overextended.”

“Within Japan there are some interesting ideas from a yield perspective. The country has made our screens because they are rapidly increasing their dividends, which is a key factor for us.”

Beyond Japan, other opportunities have arisen in the emerging markets where Mr Ehrlichman is focusing on efficiency and abundance plays. “These are firms that build electricity grids and solar power plates,” he explains. “Some qualify for yields and some don't, but we want to have some of these plays in the portfolio, including some of the laggard industrials, for example.”

He is careful, however, not to get too enmeshed in the link between emerging market countries and the current commodities boom. “The current mania and speculation in commodities could be over tomorrow,” he says. “Who knows? What we are sure of is that it is a speculative mania, which we do not believe makes sense. We would rather stay away from some of the stocks within the emerging markets that are caught up in the whole situation.”

However, while the markets in Brazil might be at record highs, China has seen its market plummet, leading to opportunities for the fund manager. “Some of the refiners have been ravaged, for example,” he says. “If you think that refined product demand is going to be strong and if some of these companies have pricing power, then some of them start to look interesting.”

The scarcity theme that has been dominant in emerging markets investment in recent years has been replaced by one of abundance.

“Abundance plays are being ignored because they have lagged for a number of years because of the fascination on scarcity plays, but I am an optimistic about the ability of the human condition. When you have billions of people trying to figure things out more efficiently and have better lives they tend to figure it out – that is where we believe the current investment plays are.”

And despite uncertainty in global capital markets, Mr Ehrlichman's message of focusing on capital appreciation and earnings growth through global diversification offers investors a potential opportunity to gain real income in the current marketplace.

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