EUROPEAN EQUITY

Seeking Out the Jewels Amongst the Rubble

Equity markets continued to fall in the first quarter of 2009, as the FTSE World Europe ex-U.K. Index ended the period down approximately 16%. More positively, global equity markets, including Continental Europe, rallied strongly in March against a backdrop of high-profile government action intended to stimulate demand and improve the flow of credit.

It appears that the wide-ranging economic stimulus measures implemented by governments since October have started to create an impact, hinting of a swifter recovery than had been feared by some. Nonetheless, the corporate environment remains poor, but the European consumer is stronger than those in other parts of the world, due to higher savings rates and less exposure to housing bubbles.

Although superficially this may seem to be a poor environment for investing, longer-term opportunities remain. Valuations are even more attractive than at the start of the first quarter, with many high-quality companies still trading at a significant discount to their long-term value. Furthermore, we believe that the testing economic conditions should benefit strong companies, allowing them to become stronger. Access to credit has resumed, but it is still restricted to companies perceived to be lower risk—meaning that lower-quality companies with weaker balance sheets may face acquisition by larger competitors or may disappear altogether, as opportunities to refinance remain scarce.

The ability to sustain profits through a difficult macroeconomic environment is now paramount. We believe that firms with a dominant market position or a strong brand are best placed to generate sustainable returns in varying market conditions.

The bottom-up perspective still appears poor, as company managements we met with reported that the macroeconomic environment is deteriorating further, with no clear signs of improvement in many areas. However, glimmers of hope exist with a few forward-looking indicators, such as economic surveys, showing some signs of bottoming out. Monetary stimulus has progressed further, with quantitative easing in the United Kingdom, United States, and Japan being received favorably by the market. Even though unemployment is rising, the European consumer has continued to spend—albeit at reduced levels from last year—and at a more encouraging rate than the rest of the world.

By sector, we currently have a preference for health care and consumer services and have reduced exposure to consumer durables and apparel, while staying underweight in financials. We continue to seek companies with quality assets that are highly financially productive or those where financial productivity is increasing significantly.

Due to the very severe correction seen in European equities, we are finding opportunities at increasingly attractive valuations. Atlantia, the Italian motorway toll operator, has been de-rated—despite resilience of traffic volumes—more than other European peers, which have all fallen on reduced traffic volumes. However, traffic volumes decreased less in Italy, as there is no viable road alternative to the motorway for many journeys there and, in addition, the rail network is quite poor, so freight traffic tends to stay on the motorway. Daimler, the high-quality franchise in the auto industry, has fallen to an attractive valuation level. Despite uncertainty over short-term trading, we believe the long-term outlook for Daimler looks better than its peers, as the company has a strong balance sheet and its products are more differentiated and more robust than those of its peers. Thales, the French aerospace systems and industrial electronics manufacturer, has an interesting mix of defense contracts—which are “defensive”—plus a number of strong franchises where spending remains strong, for example rail signaling and air traffic control.

By sector, consumer services is our largest overweight. The European consumer has been less impacted by the global downturn and sales remain surprisingly robust, with exposure to growing markets and the ability to take advantage of weak competitors. Opportunities here include Metro, Carrefour, Ryanair, and Vivendi. The ongoing strength of revenues in the health care sector is, in our view, not reflected in current valuations, and cash flows have been largely underestimated. In the industrials space, we have been very stock specific, focusing on non-cyclicals such as Atlantia and Thales, as mentioned before. Finally, we continue to be cautious in the financials sector, remaining underweight banks and becoming more focused on national champions and high-quality franchises. We have increased exposure to insurance firms, adding to Zurich Financial Services and Allianz.

The positive response to further fiscal and monetary stimulus and the resulting March rally were the first real signs of optimism in this cycle. However, the corporate environment remains poor and this continues to drive us to be very stock specific. As we have consistently emphasized, we firmly believe that the quality of companies is still extremely important. Nevertheless, we think that a focus on high-quality, cash-generative companies should help investors to find the resilient stocks needed for the short term and leave them well positioned for the long term. With markets down thus far this year, we believe there are increasing investment opportunities across a wider range of sectors, and we continue to seek out these "jewels amongst the rubble."

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