Europe: Uncertainty and Opportunity

By David R. Hines, CFA
Director of Research

The sovereign debt crisis in Europe and subsequent worldwide economic slowdown has been the top news story and at the forefront of many investors' minds for nearly 3 years. Fiscal austerity, likely restructuring of the debt of the peripheral sovereigns, and a reluctance to implement needed structural reforms within the European Union (namely, more centralized control of member country finances) will present a persistent headwind to global economic growth. Yet, in this environment of uncertainty and pessimism, we believe there are excellent investment opportunities; one simply needs to dig a little deeper to unearth them.

Securities markets are forward looking and often discount good or bad economic news well before the actual economic numbers are published. This swift incorporation of a changing economic outlook into securities prices makes investing based on the timing of economic trends notoriously difficult. For a vivid example of this phenomenon, we need only look back to the market's behavior leading up to the 2008-2009 financial crisis. Table 1 shows the performance (price only) of the S&P 500 from the end of October 2007 to the end of March 2009. The market fell by 53%, with much of the fall coming well before the National Bureau of Economic Research declared the recession.

Table 1 - Price Change of the S&P 500 from 2007 High to 2009 Low

Index	Price 10/31/2007	Price 3/31/2009	Change
S&P 500	1,549	735	-53%

Source: MSCI

A basic tenet of our core investing philosophy is that a bad economic outlook does not always equate to a bad investment outlook. Usually it's quite the opposite. This is so because investment success or failure is largely determined by the price an investor pays relative to the future cash flows he can expect to receive. A poor economic climate almost always provides great investing opportunities in the way of depressed equity prices rendered by pessimistic market psychology.

In March 2009 the economic outlook looked grim for the United States. The bursting of the housing bubble and melt down in the mortgage market engendered a massive liquidity crunch that froze credit markets. Economic activity fell precipitously; and with so much bad debt in the system, it was hard to imagine business activity wouldn't continue to deteriorate – never mind see improvement. And yet, as Table 2 illustrates, an *investment* in the S&P 500 in March 2009 provided a return of 85% (price only) through June of this year. Historic rallies are born in the depths of crises.

Table 2 - Price Change of the S&P 500 Low to June 2012

Index	Price 3/31/2009	Price 6/30/2012	Change
S&P 500	735	1,362	85%

Source: MSCI

Today the MSCI Euro Index, comprised of the countries that use the Euro as their currency, is in the throes of a severe bear market. As Table 3 shows, this index is down 48% from its October 2007 high (price only, local currency), in a bear market similar in size to the 2008-09 S&P bear market (see above). At these levels we see some interesting investment opportunities emerging.

Table 3 - Price Changes from October 2007 Highs to June 2012

Index	Price 10/31/2007	Price 6/30/2012	Change
MSCI Euro	1,373	716	-48%

Source: MSCI

Our process of identifying opportunities begins with yield, which we define as value inuring to the benefit of shareholders - including earnings, cash flow, and dividends - divided by the price of the investment. In times of economic stress and foreboding headlines, markets sell off and yields rise providing opportunity. Conversely, with good economic environments and cheery headlines, prices rise and yields fall, reducing prospective investment returns. As Warren Buffett says "you pay a high price for a rosy outlook".

A specific example of a European stock that we have liked for several years now is Diageo. It has provided excellent returns since the beginnings of the Greek crisis in October of 2009. As Chart 1 shows Diageo (Ticker: DEO) has provided a total return of almost 72% since October 30, 2009, far exceeding the MSCI Euro Index total return of -1.9%. At the time we found the valuation of the shares of this high-quality company very attractive: the cash flow yield was 8.5%, the earnings yield was over 7%, and the dividend yield approached 4%. This is a perfect example of a great company with attractive yields providing a wonderful investment opportunity in a horrible economic environment.

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Looking forward, the MSCI Euro Index looks attractive to us. Table 4 compares where the MSCI Euro Index was in October 2007 and where it is today. Good relative investment returns might come from eventual margin expansion, and the index's high current earnings and dividend yields.

Table 4 - Change in Fundamental and Valuation Characteristics of the MSCI Euro Index

Characteristic	10/31/2007	6/30/2012	Implication
Margins (Return on Equity)	15%	10%	Room for Expansion
Current Dividend Yield	2.9%	4.7%	High Current Income Yield
Earnings Yield	7.0%	8.8%	High Relative to Historic Yields

Source: MSCI

We continue to look for high quality European companies whose price has fallen more that their business fundamentals warrant. Many large global companies based in Europe generate a majority of their revenues *outside* of the Euro zone and offer attractive valuations.

We are also finding companies with healthy businesses (using the discounted cash flow models in a method described in detail in our last Research Note, "Healthcare Stocks: Attractively Valued No Matter What Happens in Washington"- July 10, 2012), that are priced as if they are in permanent decline. Two examples that fit this description are in Table 5.

Table 5 - Attractive Companies Based in Europe

Company	Current Dividend Yield	2012 Earnings Yield	% Revenues Europe	Price Implied Future Growth
ABB	3.9%	8%	39%	0%
Sanofi - Aventis	4.2%	10%	35%	-6%

Source: Bloomberg, Capital IQ, Applied Finance Group

Market Log- August 1, 2012

S&P 500: 1,375.33
10 year T-Note: 1.54%
Crude Oil: $90.30
Gold: $1,604.40