threadneedle investments

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Don’t turn your back at European equities

European politicians do not do bazookas – and investors waiting for a big bang moment to increase their exposure to Europe are unlikely to get one. Our central scenario remains that the eurozone muddles through – and there are signs of limited progress towards further integration in the last few weeks. Most encouraging has been the discussion about a banking union and an acceptance of Spain slowing its austerity programme – both suggest that politicians will be more flexible than some of us feared. The problem is that every step forward tends to be preceded by a mini-crisis and then followed by some disagreement on what was actually agreed! Things will likely remain volatile – but ultimately European valuations provide sufficient potential reward to justify taking the risk.

The interesting question is how the relative merits of Europe compare to other regions. As the debate shifts to the US “fiscal cliff” and slowing emerging markets growth, we believe that the “European discount” on global companies listed in Europe compared with similar companies elsewhere will look increasingly questionable. We continue to like quality European companies exposed to global growth and structural themes.

Cheap debt: An opportunity for some, a risk for others!

Crisis monetary measures are having interesting implications for European corporates. The collapse in the “risk free” rate has seen bond yields fall below dividend yields for some stocks (even ones that we consider to have good growth prospects). Anheuser-Busch Inbev (ABI) recently bought out a Mexican brewer using debt that cost just 2% - given the growth prospects for this market, we believe that equity investors are getting a great deal. Another example would be Atlas Copco where its corporate bonds yield less than the equities despite delivering high single-digit organic growth. This is also positive for those invested in the targets that are being acquired – we have seen some signs of returning M&A. There is no doubt that there are good businesses in Europe – and we expect M&A to increase going forward (albeit dependent on an improvement in confidence).

Cheap debt also makes it cheaper for companies to buy back their own shares – and, given that some of the companies we invest in even have net cash positions, we expect increasing scrutiny on the use of cash. In an uncertain world, it is right that corporates want to have conservative balance sheets (and it is one of the ways we screen investment ideas), but net cash is not likely to be an optimal medium-term capitalisation structure for many companies.

“The interesting question is how the relative merits of Europe compare to other regions”

Beyond raising new debt to pursue attractive opportunities, there is also an opportunity to refinance existing debt at more attractive rates. For some companies that were forced to raise debt at the peak of the crisis, the impact of refinancing can be meaningful. Lower debt servicing costs again represent a good deal for equity investors.

Part of our confidence in investing in ABI is the fact that management own shares and has a track record of disciplined M&A. However, what is an opportunity for companies like ABI that are investing wisely, can be a risk elsewhere. Cheap debt can make even poor deals look attractive on an EPS accretion basis. The implications of cheap debt for capital allocation are a bit worrying – because distorted decisions now could prove expensive

over the long run (a horizon that gets little attention today – but is relevant when evaluating M&A and capex). We worry that industries with growth problems may destroy value trying to grow – when they could be great returns and cash distribution stories.

Time for value?

Given the strong performance of "growth" stocks relative to value stocks, some investors are questioning whether we are due some mean reversion. We would make a couple of observations about this.

Firstly, nothing ever happens in a straight line so occasionally cheap stocks will get too cheap and have a bounce. While we maintain our preference for quality in an uncertain world, we are very diligent in looking for special situations where we think the market is mispricing stocks. For example, we have recently been buying Eon on our funds to reflect an improvement in its outlook - following several years of disappointment. We believe that it has reached a turning point. The idea is that this remains a bottom-up search for companies to invest in rather than a top-down shift to value. We continue to believe that quality companies will outperform in the long run as superior fundamentals avoid mean reversion.

Secondly, we do not think that value should necessarily be thought of as the opposite of growth. There are still plenty of stocks with good growth that we think have attractive valuations. The clear danger is that some stocks re-rate as perceived safe havens to expensive valuations while their fundamentals are going in the other direction. A potential example of this would be consumer staples – an area that we really like for the long run but have become a little more cautious on near term due to their valuation re-ratings and short-term headwinds. We see an increasing need to be selective in sectors like consumer staples, for example, despite a strong run of share price performance. ABI continues to offer a 7% free cash flow yield.

The search for yield evolves

The search for yield goes on – as bunds have headed into negative real territory, it is forcing investors to look at other asset classes. We would note the increased interest in infrastructure assets for this reason – companies like Ferrovial and Eon have been able to sell regulated assets at attractive valuations over the last couple of years (and for more than equity investors have been willing to give these companies credit for).

The other clear implication is the relative attraction of the yield of equities themselves. The apparent index yield is clearly unsustainable – given that it includes some companies where dividends will either be cut, be paid in scrip or be offset by rights issues. However, we still think there are plenty of very reliable, attractive dividend opportunities out there. The Threadneedle Pan European Equity Dividend fund offers a current yield of 4.8%, but also offers exposure to any improvement in the economic outlook in the medium term. By its nature, it also has a value skew so it should also be well positioned in the near term for any improvement.

Business as usual

"Value and growth are not mutually exclusive"

While the market has been and will remain volatile, we continue to have confidence in the investment approach that has driven the strong long-term performance track records across our funds. A sound investment process is more important today than it has ever been, as it allows us to filter out the considerable short-term noise and focus on longer-term opportunities – this is very much business as usual for the Threadneedle European equities team.

"It is not necessary to own beaten up banks to gain exposure to a European recovery"

Finally, we would stress that investors do not need to buy the most optically cheap, beaten up bank they can find in order to gain exposure to a European recovery – we see good upside in quality European companies as the "Europe discount" unwinds, without the obvious risks attached to owning banks in a deleveraging world!

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