Viewpoint

European Equities – July 2013

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Buying companies not indices

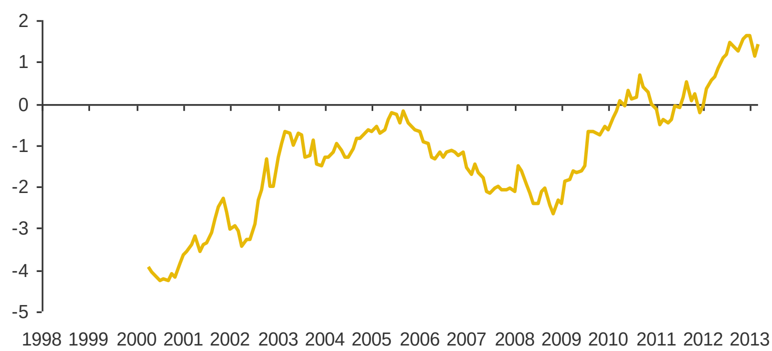
Everybody knows the negative story surrounding the European economy and the difficulties companies face conducting business on the Continent. We believe that the challenges facing Europe will ultimately be overcome, but it may take years to achieve the necessary restructuring measures. However, it is worth reminding people that we invest in stocks and we believe that there are some very good opportunities that exist now among selected European companies.

The eurozone's economic problems are creating opportunities for investors because, as figure 1 shows, we can buy into high quality companies more cheaply than in the rest of the world. While only the most robust business models will succeed in the current hostile environment, it is our view that the strongest companies will get stronger.

Figure 1: Tapering is not tightening

Valuation levels[1]	Index Level	2013E PE	2014E PE	PCF	2012 yield (%)
US - S&P 500	1,643	15.0	14.3	9.5	1.7
Europe – MSCI Europe	**101.3**	**13.6**	**12.8**	**10.4**	**3.2**
Japan – TOPIX	1,057	16.7	13.2	6.9	2.7
Asia Pacific ex. Japan – MSCI Asia Pacific ex Japan	446	11.3	10.3	9.0	3.1

Dividend yield vs. cost of debt[2]



1 Source: Threadneedle Investments, Bloomberg, as at 7 June 2013; 2 Source: Barclays, as at 1 March 2013.

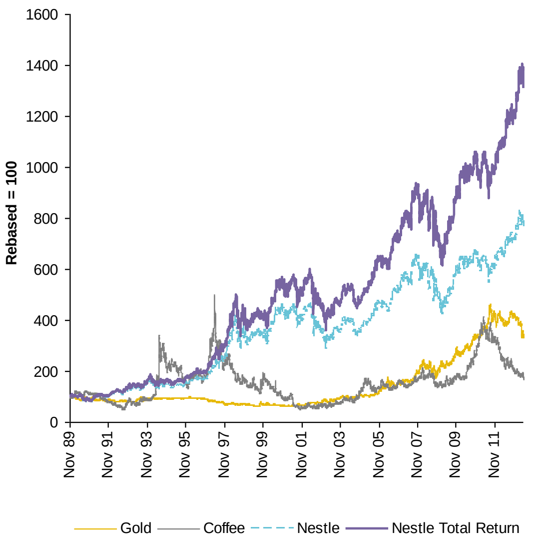
European companies in general – and the ones we target in particular – are increasingly focusing on global markets and this is helping them compensate for the impact of troubled domestic markets. The balance sheets of non-financial companies are also increasingly robust.

Our strategy involves buying companies that we believe in and holding them for the long term. We certainly do not try to trade through the risk on/risk off cycle, nor are we trying to call the bottom of the market. We simply focus on the strongest companies in whichever European market they are located.

Nestle provides a good example of the type of company that we invest in and has performed very strongly for a long time as is clear from figure 2 overleaf. Nestle has a leading position in a number of markets, which are geographically diversified. It is particularly strong among faster-growing emerging markets and is exposed to various secular growth drivers such as eating out and nutrition. The company has a triple 'A' rating and can fund itself very cheaply. At the same time, the dividend on Nestle stock currently yields more than its bonds.

Chinese coffee consumption provides an example of the trends Nestle is benefiting from. The Chinese, on average, drink around three cups of coffee per annum, of which two are supplied by Nestle. By comparison, Hong Kong residents drink around 168 cups per annum, suggesting huge scope for future growth from mainland China.

Figure 2: Gold Blend… better than gold!



- Nestlé has outperformed the gold price
- It has also outperformed coffee
- Nestlé's ability to generate income has been a key part of this outperformance

Source: Datastream as at 31 May 2013. The mention of specific stocks should not be taken as a recommendation to deal.

Ryanair is another business that we favour. It has a strong balance sheet and generates a lot of cash. As a low-cost leader in a consolidating industry, the company has benefited from consumers trading down in an era of austerity. Ryanair is gaining market share while lower capacity growth means that it is also able to charge higher fees.

The return of the `Nifty Fifty'?

Attractive dividend yields and the ability to sustain those dividends is one of the factors that we look at when assessing a stock. Indeed, in a low growth and low yield world these are increasingly important factors. Although the search for yield means that these stocks have been in strong demand, we believe that they can continue to deliver strong overall returns to shareholders. This, after all, was certainly the case with the `Nifty Fifty` stocks, the name given to a group of US large cap stocks including household names such as American Express, IBM, Procter & Gamble, Disney and McDonald's. These companies were found in a variety of sectors but had common features such as growth potential and a competitive advantage in their own particular fields. The approach was the same as ours today: buy and hold. Over the eight years from the end of 1964 to the summer of 1972, for example, the `Nifty Fifty` outperformed the S&P 500 by 189%, or around 15% a year. This achievement is particularly remarkable given the S&P 500 barely advanced over this period.

In conclusion, although the outlook for European economies is likely to remain very challenging, it is important to remember that it is not where you are born that matters; it is what you do. In this context, investors should look at Europe's difficulties as an opportunity. These difficulties are depressing share prices in general and creating an opening to invest in very well-managed, world class companies, which are not particularly focused on European domestic demand, at very attractive prices.