Europe: Malaise, QE and Pockets of Value

Amid political and macroeconomic uncertainties, there’s a tendency to paint the entire European investment picture as dark and foreboding. Like always, many investors turn away from the bleak and head to the bright lights of rising markets. But our global research analysts indicate that could be a mistake because amid Europe’s malaise, we’re searching for pockets of value.

With the recent European Central Bank’s quantitative easing (QE) announcement, investors might be asking if this is a game changer and a new reason to take another look at Europe. Although we consider the macro environment in which a business navigates, we don’t spend our time trying to predict what will happen, rather we analyze and debate the assumptions that are priced in at the company level. For instance, is the market underappreciating the type of recovery a business may experience, or is the market demanding too high of a discount rate when assessing the value of future cash flows? Once we understand what the market is pricing in, investments are only made if our fundamental analysis indicates that such a price represents a large discount to our estimate of the company’s long-term true worth.

We feel value investing is a very attractive strategy in areas of the world that have been written off at a macro level. Value is designed to take advantage of mispricing—to invest in companies that appear heavily discounted due to the anxiety of the market, even though such short-term concerns may have little impact on the true worth of these companies. We’re searching for pockets of these mispriced companies and are willing to be patient given our long-term investment horizon. In fact, our intrinsic value estimates (i.e., what we believe a particular company is worth) actually incorporate the time it may take for a business to reach its full potential.

One thing is clear: in our ongoing bottom-up analysis, in search of value globally, we will continue to monitor the situation in Europe and how the recently announced QE reforms could impact individual companies.

Below are five metrics that indicate to Brandes that there are pockets of value in Europe:

1. **Valuations**—European equities appear inexpensive, especially compared to U.S. equities, as does the value portion of the market
2. **High Dividends**—which can be a contributor to long-term performance
3. **Depressed Corporate Profits**—which leave room for improvement
4. **Diversified Revenue Streams**—with many European firms generating revenue from emerging markets
5. **Signs of Progress**—including fiscal and labor reforms
1. Valuations: European Equities Appear Relatively Inexpensive

In our view, the price paid for an investment can greatly influence future returns over the long term—more than any other factor affecting stock-price returns.

**Historically Low on an Absolute Basis**

Compared to their historical average valuations, European stocks currently look appealing. For example, by yearend 2014, the price-to-book ratio of the MSCI Europe Index was 22% lower than its 20-year average and its cyclically-adjusted price-to-earnings (CAPE) ratio was 31% lower. What’s more, while past performance is not a guarantee of future results, when Europe’s CAPE has been at these levels in the past, subsequent three-year returns averaged in the double digits.

**Low vs. U.S. Stocks**

European equities also look attractive on a relative basis, most notably compared to the U.S. equity market. At yearend 2014, European equities traded at a 38% discount to U.S. stocks based on price-to-book ratios—and at a 28% discount in terms of price-to-cash flow.

On a CAPE basis, European equities traded at a 47% discount to U.S. equities as of December 31, 2014. This is the largest discount level seen in the last 30 years, during which the average discount was 18%.

**Why Value Looks Attractive**

Challenging macroeconomic environments have led many investors to gravitate toward lower volatility and higher perceived “quality” stocks (i.e., those that score well on measures such as return on equity and return on assets). In Brandes’ experience, these shifts have resulted in a cyclical averseness toward value stocks, as investors seem more willing to pay a premium for perceived safety and growth potential. Consequently, the value portion of European equities is currently much more attractively valued than it has been historically relative to the overall market based on comparisons of price-to-book, price-to-cash flow or enterprise value-to-sales ratios as shown in Exhibit 1.

If such relative valuations spreads, mentioned above and shown in Exhibit 1, recover toward historical averages, that would be an indicator of value stocks outperforming the wider market.

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Past performance is not a guarantee of future results. One cannot invest directly in an index.

1. Source: Brandes Investment Partners, MSCI via FactSet as of December 31, 2014. MSCI Europe Index Price-to-book was 1.8x, the 20-year average was 2.3x.
2. Source: Brandes Investment Partners, Morgan Stanley, as of December 31, 2014. CAPE (Cyclically-Adjusted Price Earnings Ratio) defined as inflation adjusted price to 10Y average earnings per share from continuing operations. CAPE attempts to show the relationship between price and multi-year average company earnings in order to better estimate long-term earnings power. This valuation measure seeks to smooth out earnings fluctuations caused by business cycles while also reflecting the long-term effects of inflation. MSCI Europe Index CAPE was 14.3x, the 20-year average was 20.4x.
3. Source: Brandes Investment Partners, Morgan Stanley, MSCI via FactSet as of December 31, 2014. European stocks represented by the MSCI Europe Index. At 14.3x, Europe’s CAPE was in the 6th valuation decile (1=most expensive, 10=least expensive); when it has been in the 6th valuation decile, subsequent 3-year annualized returns averaged 12.2%.
5. Source: Brandes Investment Partners, Morgan Stanley, as of December 31, 2014. Past performance is not a guarantee of future results. European equities represented by the MSCI Europe Index; U.S. equities represented by the S&P500 Index. One cannot invest directly in an index. CAPE: Europe 14.3x, U.S. 27.1x.
2. Higher Historical Dividends vs. U.S. Stocks

Europe’s dividend of 3.3% as of yearend was higher than its own 20-year average. Although dividend history is not a primary criterion for how we select value stocks at Brandes, it can play a role during the course of owning the investment as a contributor to long-term performance. For instance, a November 2012 Brandes Institute study found that, using data from 1926-2011, the income component of equity returns became larger than capital appreciation at a 10-year horizon, and then increasingly dominant as horizons extended.

Investors searching for yield globally may be interested to know that compared to the U.S. market, the dividend yield for the European market was 69% higher as of yearend.

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Source: Brandes Investment Partners, MSCI via FactSet as of December 31, 2014. 20-year average: 3.0%. Europe represented by the MSCI Europe Index. The declaration and payment of shareholder dividends are solely at the discretion of the issuer and are subject to change at any time.
3. Depressed Corporate Profits Leave Room for Improvement

Corporate profits in Europe were about 14% below their 10-year inflation-adjusted average. While this level of profits may appear to be a near-term negative, it can create opportunity for long-term value investors. In our view, the combination of low valuations and low profits could provide investors with an opportunity to benefit from potential capital appreciation if both measures recover toward historical averages.

We believe corporate profits are one of the most mean-reverting data series out there (meaning that they tend to go back toward historical averages). Some potential catalysts for a reversion to the mean could include: industry change or consolidation, operational efficiencies, or an economic improvement. Economic improvements can alleviate pressure on both gross margins and via operating leverage—especially for those firms with higher fixed costs—and have the ability to enhance profits. As these factors will affect companies and industries in different ways, we believe it’s important to take a bottom-up view in the analysis. In our opinion, now may be the time to search for companies that may benefit from an eventual earnings recovery.

Europe offers a contrasting picture to what we see in the United States, where corporate profits have been about 25% above its 10-year inflation-adjusted average.

4. Diversified Revenue Streams

While the macroeconomic picture across the continent may appear cloudy, investors must not forget that many Europe-domiciled corporations are quite diversified. For instance, European corporations derive over a third of their revenue from emerging-market regions, which represent 39% of global Gross Domestic Product (GDP) and are forecasted to deliver over 70% of global GDP growth in 2015. In fact, European corporates actually derive less revenue (46%) from their home region than do U.S. corporates (66%).

Among developed countries in the Organization for Economic Cooperation and Development, European Union member states accounted for 58% of total exports in goods in 2013. In fact, half of the top 10 goods-exporting countries in the world are within Europe.
5. Signs of Progress

Austerity has helped balance primary budgets in the euro zone, as shown in Exhibit 2.

Additionally, some countries have made progress on other areas of structural reforms. In Spain, these include pension reform and streamlining government administration.

Importantly, labor competitiveness in many countries (including France, Portugal, Spain, Ireland, and Greece) has improved with unit labor costs declining over the past few years to levels that are actually lower (i.e., more competitive) than a decade ago.\(^\text{16}\)

The question is will the recent central bank action buy time for these signs of progress to take hold?

Also, would political developments stand in the way of reforms? For example, in Greece, there are uncertainties over the implications of the anti-austerity Syriza party’s recent election victory on efforts to promote stability and growth in the euro zone.\(^\text{17}\)

Amid prevailing uncertainties, we are encouraged by signs of progress in Europe.

The Picture of Europe: Pockets of Value

Brandes believes how investors allocate to European equities (i.e., active vs. passive strategies, value vs. growth style) has a strong influence on the corresponding investment results over the long term.

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\(^{16}\) Source: OECD Economic Outlook, November 2014. Unit labor costs relative to weighted labor costs in competitor countries. Competitiveness-weighted relative unit labor costs for the overall economy in dollar terms. Competitiveness weights take into account the structure of competition in both export and import markets of the goods sector of 49 countries. An increase in the index indicates a real effective appreciation and a corresponding deterioration of the competitive position.

Value Has Outperformed Growth in European Equities

Cumulatively, the MSCI Europe Value Index has delivered 1.5x the return of the MSCI Europe Growth Index since its 1974 inception. Even though European value stocks have been out of favor in the last several years, over the long term, they have actually outperformed their growth counterparts for longer stretches of time and at greater magnitudes, as illustrated in Exhibit 3.

Exhibit 3: Rolling 3-Year Annualized Relative Return
MSCI Europe Value Index less MSCI Europe Growth Index, EUR

Value investing has tended to thrive in bleakness because that’s where mispricing and value potential can be found.

It has been a challenging time for value investing over the last few years. However, we believe this has created an attractive value opportunity. Here’s why—if valuation spreads shown in Exhibit 1 (on page 3) recover toward historical averages, that would be an indicator of value stocks outperforming the wider market.

Conclusion

In summary, amid Europe’s malaise and regardless of central bank action, we are seeking pockets of investment opportunity. Value investing has tended to thrive in bleakness because that’s where mispricing and value potential can be found.

While we can’t predict where valuations will go, we can make fundamental investing decisions based on the wider-than-average discounts seen in many European companies (see Exhibit 1). We believe these discounts, combined with other factors mentioned above, bode well for investors willing to pursue currently out-of-favor businesses in the region.

We believe it is best to avoid the bright lights of rising markets and dig into the malaise.

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Source: MSCI via FactSet as of December 31, 2014. Cumulative growth since inception (December 31, 1974): MSCI Europe Index 6,169%; MSCI Europe Value Index 7,404%; MSCI Europe Growth Index 4,778%. MSCI introduced the MSCI Europe Growth and Value Indexes December 8, 1997. Data prior to this date is the result of back-testing performed by MSCI. There are frequently material differences between back-tested performance and actual results. The MSCI Europe Index inception date is December 31, 1969, and the performance data shown is actual and not the product of back-testing.
ECB Announces Asset Purchase Program to Jumpstart Euro Zone Economic Growth

The European Central Bank (ECB) announced in January that it will launch an expanded asset purchase program amounting to €60 billion (US $69.7 billion) a month starting in March—a move aimed at restoring economic growth in the euro zone. Market participants viewed the news as a positive sign, as indicated by the rise in many euro zone equity markets after the announcement.19

Problems of high sovereign debt and rigid labor markets have weighed on the region in the past several years. Although investors reacted positively to the news, the ECB move may not be enough to address all of the region’s problems. “What monetary policy can do is create the basis for growth,” according to ECB President Mario Draghi, as quoted in the Wall Street Journal. “But for growth to pick up, you need investment; for investment, you need confidence; and for confidence, you need structural reform,” he added.20

Key points from the announcement:

- The ECB’s program will include sovereign bonds, bonds issued by euro zone agencies and institutions, asset backed securities and covered bonds.
- The purchase of sovereign bonds across countries will be proportional to the size of the country.
- The ECB will buy mostly German, French, Italian and Spanish bonds.
- The program will run from March 2015 to the end of September 2016, with the ECB purchasing at least €1.14 trillion of securities in that time frame.
- Mr. Draghi said at a press conference that the asset purchases will continue until the end of September 2016, and “will in any case be conducted until we see a sustained adjustment in the path of inflation which is consistent with our aim of achieving inflation rates below, but close to, 2% over the medium term.”21
- The ECB said it is pari passu with other investors, which means it will rank alongside other private creditors. This is very important because it removes concerns of preferential treatment in case of default or restructuring by any member country.22

How does the ECB action inform our thinking as long-term value investors?

“How while the ECB’s actions garner the majority of the headlines, it is not our primary focus when we think about valuing businesses,” commented Ken Little, Managing Director, Investments, Brandes Investment Partners. “Our job is to dig through the clutter of the headlines and find value gems at the company level.”

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He adds: “It would be much easier to say, given the uncertainties in Europe, that we will stay away from the region altogether. But that’s not what we have done historically nor is it what we are hired to do. We try to block out the noise, focus on the important drivers of value in a business and then take advantage of the market’s herd mentality—which typically creates mispricing of even sound businesses.”

Valuing individual companies involves a thorough analysis of many factors that drive the business. “We need to carefully understand the business, its experience in dealing with currency fluctuations, sources of revenues, etc. All these combine to help us make a sensible and prudent estimation of the true value of a company over a typical market cycle,” Mr. Little points out.

“It has been our experience more times than not that the market overreacts to headlines. This overreaction allows patient investors to put the benefit of time on their side and potentially profit when more rational thinking prevails,” he adds.

Return on equity: Earnings per share divided by equity value per share
Return on assets: assets per share divided by equity value per share

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