



**European equities**  
**October 2009**  
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Europe is as easy as ABC\*  
\* anything but cash

A large number of European companies have strong balance sheets and pay generous dividends to shareholders; many European stocks now yield more than government bonds (and more even than the corporate debt of their issuers). We believe such companies hold the key to real income growth for savers.

It is some time since we moved our European equity portfolios to being fully invested and it is a position that we intend to maintain for the foreseeable future. European economies and financial markets have undergone lasting changes over the last two years and, as a consequence of some of those changes, it seems clear that Europe's savers now have little alternative but to invest in higher-yielding equities.

This has come about because of the enormous policy shift we have seen in Western economies in response to the crisis in credit markets. Large-scale fiscal stimulus and aggressive interest rate cuts in Western economies have encouraged investors to move out of cash and into a variety of asset classes, which is why we are now seeing equity, gold and bond prices all rising at the same time.

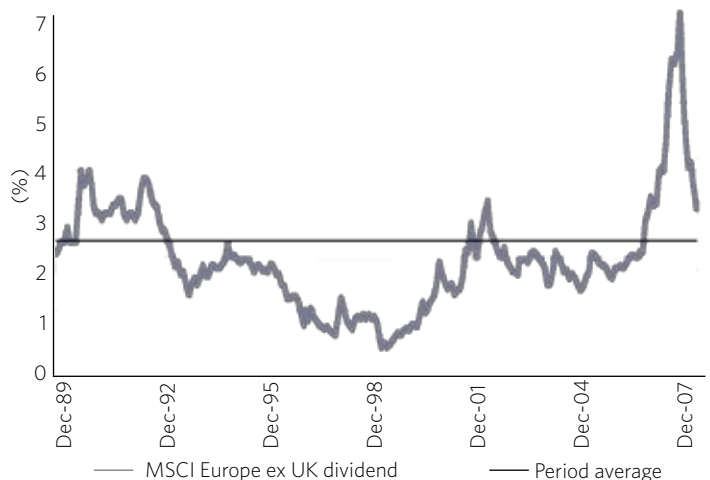
### The search for yield

Western authorities have had no alternative but actively to devalue cash, meaning that we have now reached a point at which the return on cash after tax has become almost negligible (and that is before considering the impact of inflation). The reduction of interest rates to ultra-low levels in Western economies has also sent bond yields into decline, helping to create an increasing demand for higher-yielding equities, especially in Europe where there is a large constituency of older and retired workers (who require income). Consequently, we are now seeing considerable interest from European institutions that are anxious to find reliable ways of capturing Europe's wealth of dividends. For many investors, it has become 'as simple as ABC'; they are looking to hold anything but cash!

### The attraction of European equities

Despite the rally we have witnessed in European equity markets so far this year, European shares as a whole still offer attractive value on many measures. One such measure is the equity dividend yield. Despite the large gains we have seen in some European sectors this year, the yield on the MSCI Europe ex UK Index has only just returned to its typical historic range; it is now consistent with the level at which it stood at the end of the 1980s (see chart below) despite the fact that, at that time, inflation and interest rates were much higher than they are today.

#### EUROPEAN DIVIDEND YIELD



Source: Newton / Lipper as at 31/08/09

Comparing historically high yields with historically low interest rates clearly makes European equities look cheap. While dividend yield is not the only measure worth considering, it is true that every numerical measure of market value has been skewed by unprecedentedly low interest rates.

A good example of this skewing is the dividend discount model of valuation. Because the model is predicated upon the 'risk-free rate' of return (typically the yield available on highly rated government debt) to discount future dividends

to today's money value, dividend payments become more valuable in today's money as interest rates fall.

Price-to-earnings ratios highlight also the attractiveness of equity investment as interest rates fall. With interest rates at 1% in Europe, the price-to-'earnings' ratio on cash equates to 100. At a time when cash will literally take a century to return the original amount invested in it, stock-market investment clearly has its merits.

### The importance of dividends

Not surprisingly, such measures have struggled over the short term to offer reliable guidance to investors during a year in which Europe's financial markets, like those elsewhere, have played host to a 'dash for trash'. Businesses that were priced as though they would become bankrupt were suddenly re-priced as going concerns. Such a 'relief rally' is not uncommon at turning points in equity market fortunes but, by definition, relief rallies tend to be self-limiting. After all, you can only be relieved once that a company is not insolvent!

Meanwhile, Europe's true heavyweights, many of which are global champions in sectors such as telecommunications and energy, have been left behind because they were never priced for bankruptcy in the first place.

Now we are nearing the point at which European investors will have to switch from re-rating the market's most distressed stocks to re-rating the eventual winners. At the same time, the monetary and fiscal stimulus that has been deployed in attempts to ease conditions in European economies could easily result in inflation 'bulging through the cracks' at some point (an idea that is encapsulated in our *fire risks* investment theme). If this happens, it will provide yet another reason for European investors to identify large, high-yielding companies. Unlike cash and bonds, the shares of such companies

provide a real (if only partial) hedge against inflation because corporate earnings and dividend payments, unlike bond coupons, tend to grow when inflation rises.

In effect, so long as Europe's governments continue to apply stimulative policies to their economies, they will be helping the prospects of some of the Continent's strongest and best-managed companies. Many of these companies already pay more to their investors than is available from their bonds (or indeed from government bonds or cash). We believe such companies are key to providing investors with a solution to Europe's mounting income crisis.

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