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Shopping for bargains in Europe

European equities have always offered investors an attractive combination: the ability to invest in stable, well-managed economies, together with exposure to global growth across a number of regions. Operating in an open economy with a successful export sector, European companies have long benefited from the expansion of economies in Asia, Latin America and the Middle East. With a huge diversity of well-established blue-chip companies to choose from, Europe provides a number of opportunities in which to invest; and, with the European market being one of the cheapest in the world, now appears to be an excellent time to invest in some of Europe's best companies at compelling valuations. In this article we set out what we believe are the key reasons to be invested in Europe:

1. Resilient domestic demand. It may be surprising, but the European consumer is currently in good health. Household debt has been kept to a relatively low level, at a modest 60% of GDP (compared with 100% in the U.S.). Although certain countries in Europe, such as the UK and Spain, have seen housing bubbles develop over the past decade, the core of Europe has seen very little in the way of price rises. House prices in Germany, for example, have been flat for the last three decades. Instead of increasing their housing-related debt, consumers in Europe have been prudently saving 13-15% of their incomes over the past decade and this should give them room to continue spending even as times get tougher. This bodes well for companies that rely on domestic demand.
2. A diverse earnings stream. For Europe as a whole, exports represent 44% of GDP. As global GDP picks up, Germany in particular has been benefiting enormously from its status as 'workshop of the world'. German tools and technology are exactly what China and other emerging markets need

in order to build their infrastructure and expand their economies. Whether it is high speed trains, power grids or telecommunications networks, European companies are at the forefront of providing the right technology.

3. A strong and stable currency. Backed by a credible central bank, the euro is becoming a viable alternative to the U.S. dollar. Emerging-market governments have already diversified their foreign-currency holdings away from the U.S. dollar into the euro, and this trend looks set to continue. For overseas investors, a strong and stable euro will ensure that investors' wealth is protected.
4. Last but not least, Europe is the cheapest developed market in the world. This is illustrated by the data below:

	MSCI Europe	MSCI US	MSCI Japan
Price-to-earnings ratio	12.5	14.6	17.7
Dividend yield	3.7%	2.3%	1.8%

Source: Bloomberg

The dividend yield of 3.7% offered by the European market is of particular interest to us, and it compares favourably with the German government bond yield of 3.3%. A cheap market gives rise to plenty of opportunities to buy the shares of good companies at reasonable prices. Currently we are seeing some attractive stocks, within both the value and growth universes. This is evident in the following per-share data relating to two examples, one a 'value' stock and the other a 'growth' stock.

A. BAE Systems (trading currently at 370p)

Cashflow	27p
Earnings	40p
Dividend	15p

This puts BAE Systems on a price-to-earnings ratio of 9.2x, close to its all time lows. The 15p dividend represents a yield of 4.1%, which is well covered by cashflow and earnings. This is typical of a number of 'value' stocks that are yielding even more than the market's 3.7% yield. Others include Deutsche Telekom (on a massive 7.7% yield) and E.on (5.3%).

B. Roche (trading currently at SFr 182)

Earnings	SFr 14
Growth in earnings (2009/12)	15%
Dividend	SFr 6

Roche is a clear example of a stock whose long-term growth is, we believe, being underappreciated by the market. A price-to-earnings ratio of 13x is close to all time lows, yet the company's earnings growth of 15% is as high as it has ever been. A dividend yield of 3.3% is unusually high for a growth stock such as this, and furthermore we expect this dividend to grow in line with earnings.

We take a global approach to investment, by asking each of our 20 industry equity analysts to analyse their sectors on a *global* basis. What this means is that our analysts will always seek the best investments in the world, regardless of where they are based. Europe is home to many of the world's top companies – companies with a strong global position, a history of generating strong returns for shareholders and a culture of paying high dividends. However, many of these high-quality companies have fallen out of favour recently with the market. This has created an opportunity for us to buy these stocks at attractive prices. As the 'relief rally' of the last nine months fades, we believe that high-quality European stocks with a proven track record will regain their shine.

All data is sourced from Bloomberg unless otherwise stated.

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