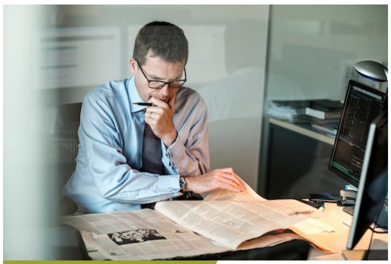
Friday Morning Coffee

Nr. 37 — Christmas double edition: All eyes on Europe & value in 2019?



This year has been difficult for investors into European equities and more particularly for investors into smaller European value stocks. According to Bank of America Merrill Lynch, we have now seen an impressive 40 consecutive weeks of outflows in Europeans stocks as investors have been fleeing. The reasons for this negative investor sentiment are well identified and documented. First we witnessed a lot of political uncertainty around a populist government in Italy, the imminent end of the Merkel era in Germany, the Brexit uncertainty and recently the yellow vest movement in France. Then a looming trade war took its toll at a moment where the economic momentum is slowing in Europe and the ECB is starting to withdraw from its exceptional quantitative measures of quantitative easing. The positive elements of sustained earnings growth, a weakening Euro strengthening exporters and a falling oil price helping the consumer did not alleviate these concerns.

We remain convinced that *Mr. Market* has priced in an excessive amount of pessimism when it comes to European equities. Valuations are now at historical lows in Europe as can be seen in the Bloomberg graph below. The forward price earnings ratio for example is at a 5 year low and at its 10 year average.

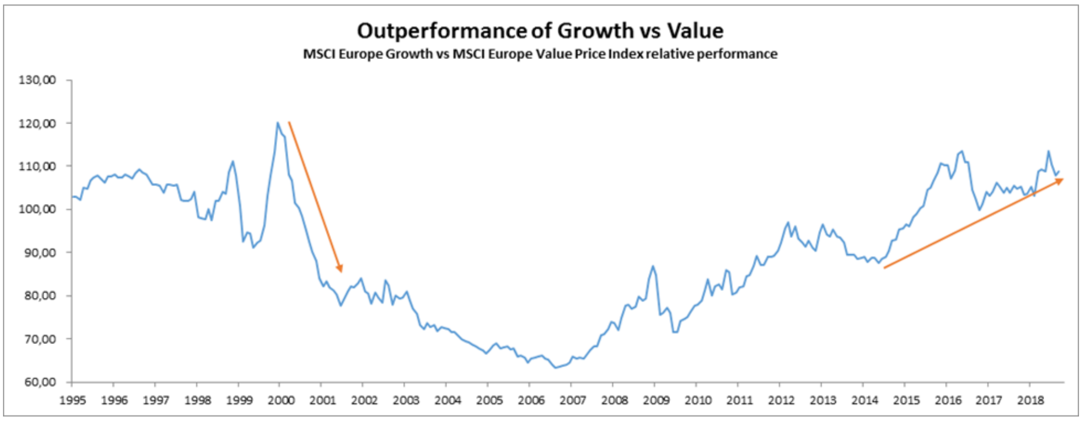
Source: Bloomberg, ECP

Pessimists argue that this low valuation is well deserved. However we would claim that this environment gives us the biggest investment opportunities since we launched our European strategy at ECP in December 2014. While it is correct that the leading economic indicators have deteriorated, the overall economic situation remains benign and companies continue to grow their earnings. From where we stand, it seems like *Mr. Market* has valued many companies, and entire industries, in an overly pessimistic way.

The weak stock markets lead to a portfolio at ECP where the overall margin of safety, i.e. the discount to our estimated fair value, is at a historical high. At the same time, we saw dramatic price corrections in a number of companies we deem, after careful due diligence, being of excellent quality with strong business franchises generating strong cash flows. This enabled us to add new investments to our portfolio at attractive valuations levels like Fresenius, Atos or Superdry.

In these turbulent times, we find it useful to remind ourselves what investing in the stock market is actually about. By buying a stock, we buy ownership rights in a company. As business owners, we are entitled to a fraction of the income stream that business generates under the form of dividends and reinvested earnings. Hence we participate to the future development of these businesses, in good times and in bad times, for as long as we stay invested. The stock market is the marketplace where the buyers and sellers meet and these ownership rights are traded. The stock prices vary second by second and are merely a reflection of what investors have been willing to pay for these ownership rights in the last transaction at a specific moment in time. Value investors, as ourselves, invest in a company when they believe the share price is at a significant discount to the fair value of the business. They are doing a fundamental arbitrage by investing at a discount to the fundamental value and hold on to the stock till the fair value is reached, a process that takes an unknown amount of time. Sometimes it can go really quick as when we invested in Shire Pharmaceuticals earlier this year and within 2 weeks the company received a take-over offer unlocking significant value. Other times the unlock of value may take several years. Once their fair value is reached, value investors typically sell the position and look for other opportunities trading at significant discounts to the underlying fundamentals of the business. What is important here is that the fundamental value of a business does normally not change overnight, not even in quarters. That does not mean that the patient value investor is inactive during the holding period of his investment. Like an entrepreneur, he is following the company closely, analyses the quarterly results of the company, the competitive landscape, the operating environment and all the factors that could affect his investment case and the estimated fair value of the business. With this mindset he takes a long-term perspective on the daily noise in the stock market. Benjamin Graham, the father of value investing, famously qualified the stock market as the manic-depressive *Mr. Market*, frequently offering to sell his share of a business or to buy at prices varying largely as *Mr. Market*'s estimate of the business's value goes from overly pessimistic to wildly optimistic.

I remain convinced that *Mr. Market* is for the moment in an excessively depressive mood. This is particularly true when it comes to value stocks. The below graph as a reminder that a/ Value is at a historically high discount towards Growth in Europe and b/ The moment value returns the outperformance is substantial and usually happens within a short period of time. A good example is the outperformance of value when the dotcom bubble burst in 2000.



Source : Bloomberg, ECP

All the above makes us confident that we are currently in the right spot with our investment philosophy focusing on undervalued earning power in Europe. We focus on applying our value investment process with discipline and consistency. That is how I created value over the last 17 years I apply this investment philosophy. I do not see why this is about to change.

Friday morning coffee will be back on Friday, January 4th 2019.

On behalf of the whole team at ECP, I wish you a Merry Christmas and a good start into the new year,

Léon Kirch, CFA
Partner & Chief Investment Officer
December 21st , 2018