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PAAMCO Perspectives

A Window of Dispersion Creates Alpha Opportunities in European[1] Equities

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After a period of relative calm following the market-supportive "we will do whatever it takes" comments from European Central Bank (ECB) President Mario Draghi in mid-2012, negative headlines about Europe have reappeared in recent months. "Hopeless", "self-inflicted," and "playing Russian roulette in Cyprus" are recent descriptions in various news media of the latest handling of the European crisis. 2013 began as a year of optimism, as European equities experienced significant inflows. However, sentiment indicators such as the MSCI Europe Relative Strength Index (RSI), which hit a multi-year high in January, have corrected since early 2013 and net flows into European equities have reversed since the Italian elections and developments in Cyprus. Europe has significantly trailed the US and Japan throughout the first four months of 2013, as the Euro Stoxx 600 is up just 5.8% versus the S&P500 and Topix at +12% and 18.7% respectively.[2] So where are we now? How should one view the current opportunity set in Europe? Europe offers primarily long/short alpha opportunities, in our view, and there is much to do.

2013 began as a year of optimism, as European equities experienced significant inflows. However, sentiment indicators have corrected and net flows into European equities have reversed since the Italian elections and developments in Cyprus. So where are we now?

Is there positive market beta left in the near term? Unlikely.

European equities experienced significant multiple expansion in the last few months and no longer appear cheap. The cyclically adjusted price-earnings ratio (CAPE) for continental Europe may look inexpensive relative to global equity markets at approximately one standard deviation below average. However, this level is pricing-in a substantial 6% expected earnings per share (EPS) growth as the ratio uses a 10-year look-back window for earnings (which includes the earnings bubble period 2006-2008). Assuming a more realistic 3% trend growth rate, the valuation discount disappears. Moreover, on a simple 12-month forward basis, continental Europe is almost one standard deviation more expensive compared to global equities.[3] Meanwhile, most economic fundamentals have continued to deteriorate across Europe, with Manufacturing and Services Purchasing Manager Indices (PMIs) and European Economic Surprise Indices generally declining in the last few months. Corporate profit margins are also below the long term (20-year) average.[4] Given weak economic and earnings

[1] Most of the data used in this Perspectives is based on the MSCI (e.g., MSCI Europe) and Euro Stoxx (e.g., Euro Stoxx 600) indices which include the United Kingdom.

[2] Index returns are USD price returns.

[3] Global Equity Strategy, "*Europe: More is Needed*," Credit Suisse, 03 May 2013.

[4] European Strategy Elements, "*Next Catalyst: Bottoming of Profitability,*" Barclays, 21 March 2013.

momentum, we suggest that investors be wary of the downside risk and be cautious of European "beta" in the short term. In the medium term, however, a possible pick-up in capital expenditure and a reduction in fiscal drag could spur on profitability and upside surprises. Under these conditions, the beta trade would likely come back, particularly if conditions include relatively strong global growth, favourable ECB policies (which may soon include a small and medium-sized enterprise (SME) lending program) and continued relaxation of austerity conditions in the periphery.[5]

Are there currently opportunities for Alpha? Yes.

Although long-only investors need to be mindful of the vulnerable state of the market, we believe there are many opportunities for hedged portfolios. Long/ short investors tend to do well in periods of declining correlation and increased dispersion.

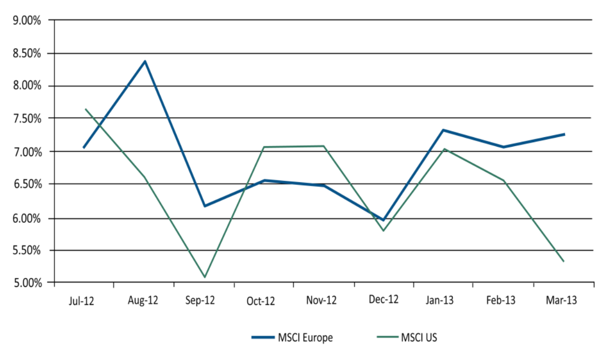
Although long-only investors need to be mindful of the vulnerable state of the market, we believe there are many opportunities for hedged portfolios. Long/short investors tend to do well in periods of declining correlation and increased dispersion[6] (dispersion is a function of correlation and volatility—dispersion increases as correlation decreases and/or volatility increases—see Figure 1). This is because reduced uncertainty usually means a decrease in the "market driven" component of a stock's performance, naturally increasing the "idiosyncratic" component. In other words, a company's fundamentals will be more influential in dictating the performance of a given stock rather than the performance of the overall market or industry (i.e., beta). Industries that are going through fundamental changes, whether for technological, regulatory or market reasons, tend to be good hunting grounds for alpha given the divergent developmental paths of companies in that industry (i.e., some companies will respond to such changes better than others). Higher volatility amplifies these moves, and creates higher dispersion and therefore the best conditions for alpha generation. As illustrated in Figure 2,

Figure 1: Relationship between Dispersion, Correlation & Volatility

	Correlation	Volatility
High Dispersion	Low	High
Low Dispersion	High	Low

Source: PAAMCO

Figure 2: Market Dispersion* in Europe and the US



Source: Morgan Stanley Quantitative and Derivative Strategies ("QDS"), April 2013, PAAMCO

***Definition of Market Dispersion:** Market dispersion is calculated as the cross sectional volatility of the (monthly) returns for the MSCI Europe and MSCI US.

[5] The periphery includes Portugal, Spain, Italy, Greece, Cyprus and Ireland.

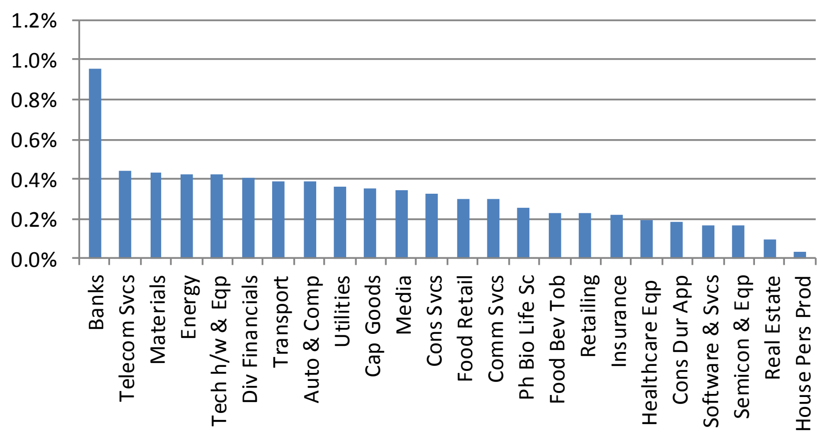
[6] Dispersion is a measure that informs us about the degree of alpha opportunities in the market. It is a mathematical concept that measures cross-sectional volatility. Dispersion is a function of both correlation and volatility. Hence it isn't always as meaningful, given that in periods of high volatility (like 2008), dispersion can look particularly high, although one would argue that is not necessarily a good stock picking environment. However, in "normal" times, dispersion can be used as a tool to evaluate the alpha opportunity set.

dispersion in Europe is elevated relative to the US. Increased European dispersion means that investors are likely to be getting paid for correctly identifying mispricings in the market on both the long and the short side.

Our current focus is on "domestically" oriented industries that have shown significant dispersion, such as financials, telecom and utilities.

Figure 3 shows that the dispersion in specific industries such as banks was particularly high within the six months up to March 2013. Our current focus is on "domestically" oriented industries that have shown significant dispersion such as financials, telecom and utilities. We are avoiding sectors such as energy, materials and technology, which tend to be exposed to global competition and commodity prices. We expect the alpha opportunity in Europe to continue to persist in domestically-focused industries for the next few years. What the financials, telecom, and utilities industries share is that they have been significantly affected by the following factors which will likely continue to play a role in driving dispersion between companies: 1) exposure to low growth Europe, 2) overcapacity/overleverage, and 3) regulatory pressures and intervention.

**Figure 3: 6-Month Average European Industry Dispersion*
(October – March 2013)**



Source: Morgan Stanley QDS, April 2013

***Definition of Industry Dispersion:** The industry dispersion calculation takes the returns per industry and separates it into a "beta" (or top down) component and an "alpha" (bottom up) component. These are two orthogonal components. The chart shows bottom-up dispersion within each industry.

We expect continued differentiation among European financials as we believe that current prices do not reflect broad differences in bank recovery, deleveraging, ability to pay dividends, and further restructuring plans.

European Financials

Recent regulatory and deleveraging pressures have forced financial companies to enact significant restructuring plans. While undergoing different stages of recovery over the past few years, banks and diversified financials (which include insurance companies, asset managers, and securities exchanges) have exhibited strong dispersion in performance, with, for example, some of the weaker periphery banks down 70% and some of the stronger core

European banks up 70% since January 2012. We expect continued differentiation among European financials as we believe that current prices do not reflect broad differences in bank recovery, deleveraging, ability to pay dividends, and further restructuring plans.[7]

Companies that have the potential to accelerate the restructuring process and start paying dividends again are particularly attractive long positions, while banks with relatively low profitability prospects and poor asset quality and/or restructuring plans are good candidates for short positions. Furthermore, the situation in Cyprus, in which senior debt-holders and depositors were "bailed in," will likely increase the differentiation between weak and strong banks, as bank creditors are forced to re-evaluate risks now that we appear to live in a bail-in world. In 2012, hedge funds investing in European banks were generally positioned long core country banks and short periphery banks, but in 2013 managers have needed to be more selective and focus on specific catalysts. Hence, more rotation can be expected.

Given what appears to be a constructive regulatory trend, the scarcity of global cable assets, and the high score telecoms exhibit on the "potential M&A" scorecard, we expect the European telecom sector to go through a multi-year cycle of recovery and potential consolidation, starting this year.

Telecommunications

The European telecommunications ("telco") industry has been left behind by the investor community for years. The sector was generally perceived to be inefficient, mainly due to different country-by-country rules which generated a fragmented market in Europe. In addition, inefficient regulation has acted as a barrier to necessary investment.

In comparison to other, more mature telco markets such as in the US, the gap in network infrastructure investment between these markets has been widening significantly since 2008, to the detriment of the European consumer and global corporate competitiveness. Investors have been sceptical of sector improvement because any substantive change requires action at the European Union (EU) level. In addition, the sector has had a very poor track record when it comes to corporate activity such as mergers and acquisitions (M&A). In fact, no significant deals have been completed since 2008. However, all this may be about to change.

The European Commission[8] appears to be waking up to the gravity of the situation, as illustrated by its 2012 proposals to create fixed line pricing conditions that can support investment. Recently the Commission has begun to tackle mobile. The Vice President of the European Commission and Commissioner for Digital Agenda, Neelie Kroes, has made it very clear in her recent speeches that network infrastructure investment is crucial for the euro area's future economic growth. Moreover, she has expressed that she is fully committed to making the European telco market more integrated, coherent, and efficient.

[7] The general outlook for bank earnings continues to be weak, given continued low rates, higher bad debts, and a weak economic growth picture. However, valuations are not necessarily reflective of these fundamentals as the discount rate for particularly strong large caps banks can be considered excessive, while on the other hand it may not be high enough for banks that are only at the beginning of their turnaround.

[8] The European Commission is the executive body of the EU that is responsible for proposing legislation, implementing decisions, and upholding the Union's treaties.

Given this regulatory trend, the scarcity of global cable assets, and the high score European telco's exhibit on the "potential M&A" scorecard[9] as a result of attractive metrics (e.g., high free cash flow yield versus bond yield, low value-to-cost ratio), we expect the sector to go through a multi-year cycle of recovery and potential consolidation, starting this year. Although analysts are still bearish on the sector as a whole (e.g., predicting that earnings for particular incumbents may be negatively impacted by competition and regulation), there has been quite a bit of corporate activity so far, with several announcements of potential mergers and asset disposals.[10]

The European utilities industry has faced substantial headwinds in recent years as a result of regulatory intervention, fundamental pressures from overcapacity, structural changes within European power markets and declining global commodity prices. Lower correlation and higher dispersion among European utilities are generating opportunity for alpha generation.

Utilities/Infrastructure

In the US, where utilities are federally regulated businesses and margin structures across utilities therefore exhibit similar characteristics, intra-sector correlation tends to be high. In Europe, the utilities sector is more liberalized on the power generation side (while regulated on the power distribution side) and "local." Furthermore, the European utilities industry has faced substantial headwinds in recent years as a result of regulatory intervention, fundamental pressures from overcapacity, structural changes within European power markets and declining global commodity prices. Lower correlation and higher dispersion among European utilities seem likely to generate opportunities for alpha.

It is important to understand the various headwinds that affect the Euro utilities:

- Regulatory intervention differs per country,[11] but, overall, it has had a severe negative economic impact on utilities across Europe.
- Industry fundamentals are weak because, over the past couple of years, energy efficiency has increased and power demand has decreased, leading to significant overcapacity.
- Moreover, there has been a structural change in European power generation markets because of renewable energy subsidies. This has led to a collapse in power prices and to utilities powered by coal and gas being priced out of the market.
- Lastly, input costs for utilities such as coal have been volatile and haven't declined enough to offset the decrease in energy prices, leading to a compression in spreads.

In order to deal with these difficult circumstances, utilities have been deleveraging and raising capital in the last few years at various speeds and levels. Winners and losers in the industry depend on how exposed firms are to the various pressures and on the plans they have in place to deal with these circumstances. Utilities with overleveraged balance sheets and relatively high exposure to the liberalized power generation market are particularly vulnerable, while utilities with more exposure to the regulated distribution side and who are in a position to

9 Global Equity Strategy, "*M&A: Further to go and Market Implications*", February 25, 2013, Credit Suisse Equity Research.

10 Potential mergers refer to Telecom Italia and Hutchinson Whampoa's Italian operation, and Vodafone or Liberty Global with Kabel Deutschland. Asset sales refer to, for example, Portugal Telecom sale of its Macau telecom stake.

11 For example, Germany decided to close down nuclear power plants after the Fukushima disaster, while Spain is imposing an effective tax on utilities due to fiscal consolidation and funding of a tariff deficit that was the result of government subsidies for renewable energy.

benefit from the current favourable interest rate environment are in a much better position. Potential "events" that can be expected are more recapitalizations, diversification moves like M&A activity in emerging markets, and defensive consolidation. One thing is clear: these companies must react to the pressures they are subjected to, which is leading to long and short opportunities.

Beware

Europe is probably not a beta play in the near term.

As indicated, Europe is probably not a beta play in the short term. Domestically-focused European stocks have sharply lagged export-oriented stocks both in terms of earnings and returns ever since the crisis.[12] In terms of sectors, financials, telecoms and utilities are among the worst performers of the Eurostoxx 600 sectors, whether on an annualized 5-year or 3-year basis,[13] and their five year CAPEs are among the lowest of all sectors (see Figure 4). This is not entirely surprising, given that these sectors tend to have lower return on equity forecasts. Suffice it to say that once profitability returns to these sectors, substantial upside could be expected.

If the ECB decides to implement a small and medium-sized enterprise loan program, it could be good for banks' margins, especially for banks exposed to the periphery. Such a program could also help utilities and telecoms as sovereign spreads would be likely to compress. Given that credit ratings of telecoms and utilities are closely tied to the sovereign spreads, this could be especially beneficial to periphery European utilities and telecoms.

Figure 4: Performance and Valuation of Various Stoxx Europe 600 Sectors

	1 YR annualized return	3 YR annualized return	5 YR annualized return	Cyclically adjusted PE (based on 5 year earnings)
Stoxx Europe 600	15.10%	4.45%	-1.66%	
Worst performing sectors				
Banks	24.84%	-7.24%	-13.94%	9.5
Telecoms	4.35%	-0.50%	-3.63%	8
Utilities	5.06%	-6.11%	-10.77%	7.5
Top performing sectors				
Food and Beverage	22.03%	15.43%	10.89%	24
Healthcare	26.52%	14.57%	10.15%	20
Personal and Household Goods	17.69%	15.94%	9.58%	24.5
As of April 30, 2013. Based on the STOXX 600 supersector price indexes.				

Source: Stoxx Europe 600 Fact Sheet

12 Eye on the Market, May 2 2013, JP Morgan.

13 As of April 30, 2013. Stoxx Europe 600 Factsheet. On a 1-year annualized horizon, banks and financial services are among the best performing sectors, while utilities and telecom have continued to lag.

The market's perception of tail risk will ebb and flow with the news. It is unlikely to increase to the levels of July 2012[14] but an increase in the perception of tail risk and the resulting fragmentation could be expected in the coming months as the calendar of "potential" tail events stays full. The biggest risk, in our view is, ironically, the democratic process in Europe itself. After all, if you couple bail out fatigue in the north and austerity fatigue in the south with elections, it could produce unexpected results, as we have seen in Italy. Importantly, Germany will hold elections in September. Although German Chancellor Angela Merkel appears reasonably strong at this point and no anti-EU party seems to have garnered significant support, any change in the status quo in German leadership could rattle markets significantly.

However, if you fundamentally believe that the "European project" is going through major growing pains but will ultimately become stronger and more integrated, you should not wait to invest. After all, where there is dislocation and complexity there also tends to be opportunity.

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[14] Which led to significant fragmentation in sovereign and bank spreads between periphery and core, putting the entire EU project at risk and prompting the "Draghi put."

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Melanie received her MBA from Columbia Business School, her Master of Science in Political Science from the University of Amsterdam and her BA in Psychology from Princeton University.

ENDNOTES

The **Citigroup Economic Surprise Index (CESI) Eurozone** measures the variations in the gap between the expectations and the real economic data. Input consists of the actual econometric data that moves foreign exchange markets. The bigger the data moves forex markets, the more significant its weight in the index. And the consensus among economists before the data is released. When the CESI is positive it means that the released data have been better than the expectations. When CESI is negative, it means that actual results have been worse than expectations.

The **Euro Stoxx 600** is derived from the STOXX Europe Total Market Index and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 18 countries of the European region: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

The **Manufacturing and Services Purchasing Managers Index (PMI)** is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A PMI of more than 50 represents expansion of the manufacturing sector, compared to the previous month. A reading under 50 represents a contraction, while a reading at 50 indicates no change.

The **MSCI Europe Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in Europe. The MSCI Europe Index consists of the following 16 developed market country indices: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

The **MSCI Europe Relative Strength Index (RSI)**, using equity market performance captured by the MSCI Europe Index, measures the magnitude of recent gains compared to recent losses in an attempt to determine overbought and oversold conditions of an asset. It is calculated using the following formula: RSI = 100 – 100 / (1+RS) where **RS** = (average of x days' up closes / average of x days' down closes).

The **MSCI US Broad Market Index** represents the universe of companies in the US equity market, includes large, mid, small and micro-cap companies. This index targets for inclusion 99.5% of the US market cap. Aggregate of MSCI US LC300, MC450, SC1750 and Micro indices. Disseminated by Amex.

The **Standard & Poor's 500 Stock Index (S&P 500)** is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The **TOPIX (TPX), also known as the Tokyo Stock Price Index,** is a capitalization weighted index of all companies listed on the First Section of the Tokyo Stock Exchange. The index is supplemented by the sub-indices of the 33 industry sectors.

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