For professional and regulated qualified investors only

Europe: where are we seeing the risks?

October 2017

Philip Webster
Director,
European Equities

Contact us

Institutional business:

+44 (0)20 7011 4444

institutional.enquiries@bmogam.com

Adviser sales:

0800 085 0383

sales.support@bmogam.com

bmogam.com/adviser

Discretionary sales:

+44 (0)20 7011 4444

client.service@bmogam.com

bmogam.com

I've written a couple of articles over the last twelve months when I've felt animated enough to put my grievances with the market down on paper.

What I wrote in September 2016 about valuations being skewed and risks being ignored hasn't really changed much, we're just another 12 months down the line and the European market* is 23% higher. To be honest, my complaint had nothing to do with the market, more the risks being taken in the pursuit of returns.

For those of you who want to read about the risk backdrop look no further than the recent memo from Howard Marks titled "There They Go Again…Again'. There are, as ever, some great quotes but the following stood out for me:

"with the negative catalyst so elusive and the return on cash at punitive levels, people worry more about being underinvested or bearing too little risk (and earning too low a return in good markets) than they do about losing money" **Howard Marks**

If you take away nothing else from this article than having a look at your portfolio risk, then it's been worth the effort. If you don't, then perhaps that's the reason we are where we are!

What Marks does say, and very honestly, is that he was very early to sell and therefore would have missed out on a lot of upside. That's an interesting debate for another time but leads on, long-windedly I admit, to what I wanted to write about, which is what I've being doing over the past year and how I've moved to protect shareholder capital in this risk-on environment.

*FTSE All-World Developed Europe Ex-UK, 12 months to 30 September 2017. Past performance should not be seen as an indication of future performance.

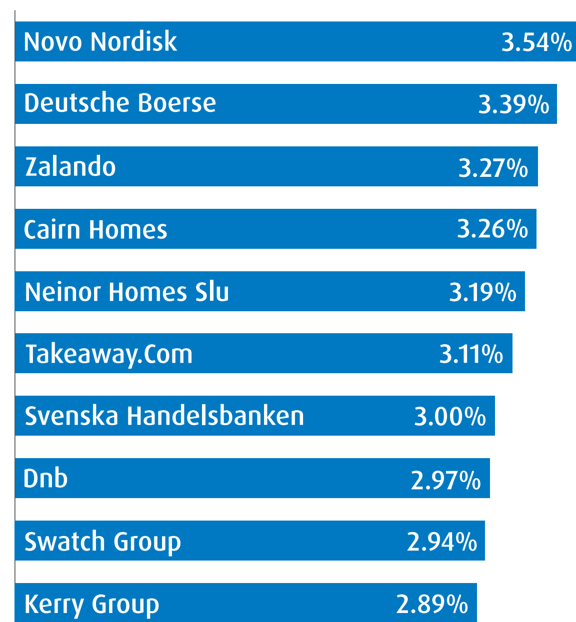
Concentrating on quality

Before we get on to what I've been doing, my simple belief is that if you say you're benchmark aware not benchmark driven then you need the conviction to back your ideas with capital. First of all, in a world where passive and smart beta seem to be taking over, I still firmly believe there is scope for a differentiated, focused equity strategy with the potential to add alpha. It's perhaps in combination with a passive strategy, that's up to those that asset allocate, but I wouldn't be sitting here today if I didn't think there were flaws in passive investing that haven't come to the fore yet. For one, you own the good, bad and ugly in a benchmark passive strategy which will offer limited downside protection.

With a differentiated product in mind, we have worked hard over the last twelve to eighteen months (since my arrival) to give F&C European Growth & Income Fund more focus. Today the fund is 32 names, from slightly above 40, and the active share is now 84%. To be honest, 32 could have been 35 or 36, I'm not aiming for a specific number but by backing those business models where I felt the moat (competitive advantage) was the widest I've improved the quality and therefore feel we are better placed to mitigate losses in shareholder capital. To fund these larger conviction positions we exited names that were either expensive, didn't warrant the capital we needed to hold or where we have experienced 'thesis drift'.

The way I think about the portfolio construction is the relative capital at risk. Below is the fund's top 10 for you to peruse, debate, question at your will. I won't cover all of these as some, like Novo Nordisk, have been written about before. [See previous article – January 2017]

Top 10 holdings – relative weight



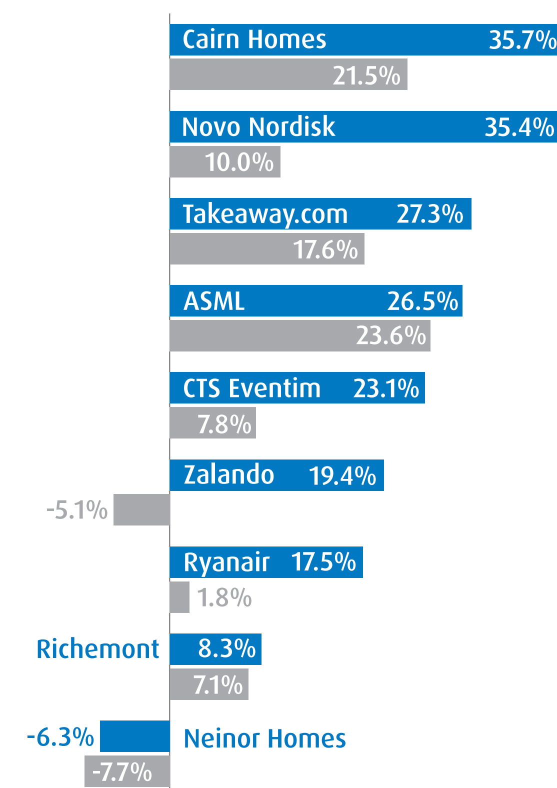
Source: BMO Global Asset Management, as at 30 September 2017.

Mindful of top-down risks

We believe in bottom-up but are also mindful that you can't ignore the backdrop as there are clear trends and themes which drive the herding mentality, which in turn influences markets. In terms of themes, 'quality-at-any-price' and the US dollar trade were clearly the most crowded trades at the back end of last year. I wrote about disconnect between growth and value back in December, and sure enough we are now seeing the end of the currency-driven upgrades as the euro strengthens and the dollar earners drift. We clearly have dollar exposure but we were early to shift our exposure towards domestic European earnings buoyed by economic growth, falling unemployment and a generally more positive set of earnings coming out of the region. This has driven a lot of the new investments we have made in the fund over the last year: disruptors like Ryanair, and online business models such as CTS Eventim, Zalando and Takeaway.com. We have also added two early-cycle housebuilders – Cairn Homes in Ireland and Neinor in Spain. Both of these have a first-mover advantage in acquiring a quality land bank and are now shifting their focus to executing on the medium-term build targets.

For completeness, I've included below all the purchases I've made for the fund and their absolute/relative performance, with Zalando and Neinor being the only holdings to have relatively underperformed since initiation.

Fund purchases – absolute (blue)/relative performance (grey)



Source: Bloomberg. Returns are from date of initiation to 30 September 2017.
Past performance should not be seen as an indication of future performance.

Continued

Links to previous articles

- European valuations: apocalyptic or opportunity? – August 2016
- It's so easy with hindsight! – December 2016
- What happens when the facts change? – January 2017
- The online disruptors – June 2017

We have also raised our conviction behind a number of names, including Deutsche Boerse, Swatch, Kindred, Heineken and Kerry Group. Swatch is a good example of a business that used to be a favourite as the Chinese 'gifting boom' lifted their sales and margins to super-normal levels. Are there some structural challenges from the Apple watch in some of the lower price point brands? Almost definitely. Was there too much inventory in the channel? Again, the answer is yes, but look at the performance of Swatch's own brand stores versus wholesale. Is Omega, their largest brand and profit contributor, broken? Certainly not! It's therefore not perfect, no investment ever is, but with a net cash balance sheet, and solid cash flows we felt the 'margin of safety' in our valuation provided decent upside potential from only modest improvements in trading. We are only at the beginning of the recovery but this is an example of the fear 'hype' turning into a reality and artificially depressing the share price – it's now up around 40% from the lows.

Financials – where to start?

This depends very much on where you sit on the quality and risk curve. Raiffeisen, UBI Banca, Commerzbank and Banco BPM lead the gainers in the SX7E (European banking index) year-to-date, all of which are uninvestable, in my opinion. That doesn't mean others shouldn't own them but they are nowhere near passing our quality screens. We own the retail banks like DNB, ING and Intesa Sanpaolo, where the balance sheets and capital are beyond doubt. Intesa was our only peripheral holding which was being tarnished for being Italian, rather than bad, which we felt presented an opportunity. Intesa is now trading around its book value, which led us to reduce our position. We weren't obliged to reinvest within the sector but I see an opportunity with Handelsbanken. Handelsbanken is, in my opinion, truly differentiated with a customer-relationship driven model and they have proven to be a quality underwriter of risk by incentivising staff correctly. I recently read a quote from an analyst on this bank (I won't name him), which took me back to the Marks quote at the start:

> "We admire the group's (Handelsbanken) risk management in the Nordic region historically; however, in a stable asset quality environment, the group's defensive attractions are unlikely to warrant a valuation premium (currently 17% premium to European banks)"

Has our strategy delivered?

I don't really like talking about performance at any one point in time as markets can make you look wrong very quickly.

At the time of writing my first article a year ago, we were a couple of percent behind the benchmark and I wrote 'keep-the-faith'. Now were are a couple of percent ahead and I'm far from patting myself on the back for this turnaround. We have made changes but we have also continued to do what we always do, which is buying quality with a 'margin of safety'. What's most pleasing is that we've managed to outperform without chasing the herd or overpaying for growth.

Preservation of capital is at the forefront of our thought process and we will continue to control the controllable; markets will do what markets will do.

Views and opinions expressed by individual authors do not necessarily represent those of BMO Global Asset Management.

Past performance should not be seen as an indication of future performance. The value of investments and income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

BMO Global Asset Management

© 2017 BMO Global Asset Management. All rights reserved. BMO Global Asset Management is a trading name of F&C Management Limited, which is authorised and regulated in the UK by the Financial Conduct Authority. Calls may be recorded. CM14413 (10/17) UK, CL