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Should Your Portfolio Vote 'Yes' on European Stocks?

By CONRAD DE AENLLE

FRENCH and Dutch voters have ushered in a fresh period of political and economic uncertainty for the European Union by rejecting its proposed constitution, but many professional investors with global stock portfolios say the region still offers better prospects than the United States over the near to medium term. Their reasoning is that the American economy has enough uncertainty of its own.

Francis X. Claro, senior portfolio manager at Evergreen Investments in Boston, said that in the United States "there's a 6.5 percent current account deficit, an environment of rising rates, some inflation, oil is very high and you have a fiscal deficit."

"It's not hard to see why investors may be reluctant to buy U.S. assets," he added.

Any outperformance by European markets would continue a multiyear trend. While American stocks have recovered recently, they are still down sharply over the longer term. The Morgan Stanley Capital International USA index was down 14.6 percent over the five years through Friday, even after factoring in dividend payments. The MSCI index of European shares shows a gain of 0.7 percent in dollars over the same period.

In 2005, the trend has held until very recently. American stocks now have a slight advantage for the year, thanks to the fall of the euro, which reduces the value of European assets for American investors. The MSCI Europe index was down 0.8 percent in dollars through Friday, compared to a 0.2 percent loss for the MSCI USA index.

The fact that the edge is so small, despite the euro's 10 percent decline this year and the recent "no" votes on the constitution, shows the resiliency of European markets. Dutch and French stocks rose modestly in the days after the referendums, although some analysts said the results could delay European economic changes.

In a note to clients after the French vote, Philippe Tibi, research director in Paris for UBS, warned that "structural reform and perhaps privatizations may also be sidelined again."

One reason the market impact was negligible may be that stocks are much cheaper in Europe than in the United States.

"We've been able to find more value in Europe," said Ray Vars, a manager of global stock portfolios at North Road Capital Management in New York. "We can buy more return on equity for a cheaper price."

Paul R. Niven, head of strategy at F&C Asset Management in London, concurred. "Europe looks undervalued compared to the United States," he said. "Some markets have very attractive yields, and companies have been giving cash back to shareholders" through buybacks and special dividends.

Tim Harris, European equity strategist at J. P. Morgan Private Bank in London, is less optimistic. He recently lightened the European stock component of his model portfolio.

About two months ago, "we took some of our European bets off the table because we saw no reason for Europe to outperform," he said. The sales amounted to 2 percent of the portfolio, he said, and the proceeds were placed in European commercial real estate. Mr. Harris suggested that investors in the United States keep the bulk of their portfolios at home.

"We tend to keep a home bias to protect against currency risk," he said.

Generally over the last five years, that risk would have been worth taking. The dollar fell substantially against the euro and other European currencies over most of that time, which accounts for much of the superior performance of European stocks. The dollar is still down by more than 30 percent against the euro over that stretch.

A weaker dollar has hurt American shares in two ways: the dollar values of assets denominated in other currencies have risen, and the shrinking of the dollar has caused some European investors to avoid American stocks. Gil Knight, senior fund manager at Gartmore Global Investments in suburban Philadelphia, warned that the same effect might occur in reverse if the dollar's recovery continued and Europeans began buying American stocks again.

But he considers such events unlikely. "Right now I would consider the U.K., Germany and Italy" as good markets to invest in, Mr. Knight said, declining to be more specific.

Mr. Niven, at F&C, also recommends being heavily invested in Europe and lightly in the United States, although he suggested that European stocks were the lesser of several evils. "Equity valuations look good, compared to bonds, but over all the outlook is uninspiring," he said. Pressed to offer some investment ideas, he said that European financial stocks look appealing.

Mr. Vars, at North Road, likes European stocks in industries offering the prospect of stable earnings growth, especially pharmaceuticals and food and beverages. Among the drug companies he favors are GlaxoSmithKline and AstraZeneca in Britain, Sanofi-Aventis in France and Novartis of Switzerland.

He also mentioned one American drug maker, Pfizer. Among food and beverage makers, he likes Diageo and Cadbury Schweppes of Britain. In other industries, Mr. Vars said that even after the increase in crude oil prices, energy concerns like Total of France and Eni of Italy are "two companies that trade at compelling valuations." He also favors the French life insurance company AXA.

There is little overlap between Mr. Vars's favorite sectors and those of Mr. Claro, at Evergreen. Mr. Claro prefers information technology, basic industries and the consumer discretionary sector, which encompasses such products as electronics and sports shoes.

And the companies he recommends are smaller, including Photo-Me International of Britain. He called it "a play on the migration from analog to digital photography." The company operates kiosks that allow users to print photographs from files stored on computer memory sticks. In Britain, France and Japan, it installs booths where customers can have passport-size photographs shot instantly.

Mr. Claro noted that France had introduced a new photo identification card for users of its state health care system. He said he expected the company's business to improve as the French sit for instant portraits. A new passport in Japan should have the same effect, he said.

Another British company in Evergreen's portfolios is Ashtead, which rents equipment to the building industry. Construction is a volatile business, and equipment rental is even more so. Lately, he said, use of rental equipment has been rising, and so are the prices that owners command.

On the Continent, Mr. Claro says he likes the United Services Group, a Dutch company that runs temporary-employment agencies in Germany, Italy, Spain, Belgium and the Netherlands. Business was up 20 percent in the first couple of months this year, compared with 2004, he said.

Another holding is Adidas-Salomon, the German maker of sneakers and sports gear. Adidas benefits from a weak dollar, he said, by manufacturing in countries with currencies tied to the dollar while conducting much of its sales in Europe.

It has improved its American business with a change of management, Mr. Claro said, and he predicts sales will grow next year when Germany plays host to the World Cup soccer tournament.

Another point in Adidas's favor is its price, he said. It sells at 12 times Evergreen's estimate of 2006 earnings.

MR. CLARO said his preference for Europe was based on more than ephemera like valuation discrepancies, foreign-exchange movements and the latest economic reports. The referendums last week may raise doubts about state-led economic changes, but he says he believes that reform is still bound to occur, even if it is one company at a time.

"Long term, opportunities in Europe are being driven by a financial discipline that is being instilled," he said. Noting that restructurings intended to make businesses run more efficiently have long been promised but seldom delivered, he added, "I think it's actually happening, and over the next 15 years we're going to see a true shift."