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Hermes Investment Management

Why European equities?

For bottom-up investors, the outlook is bright

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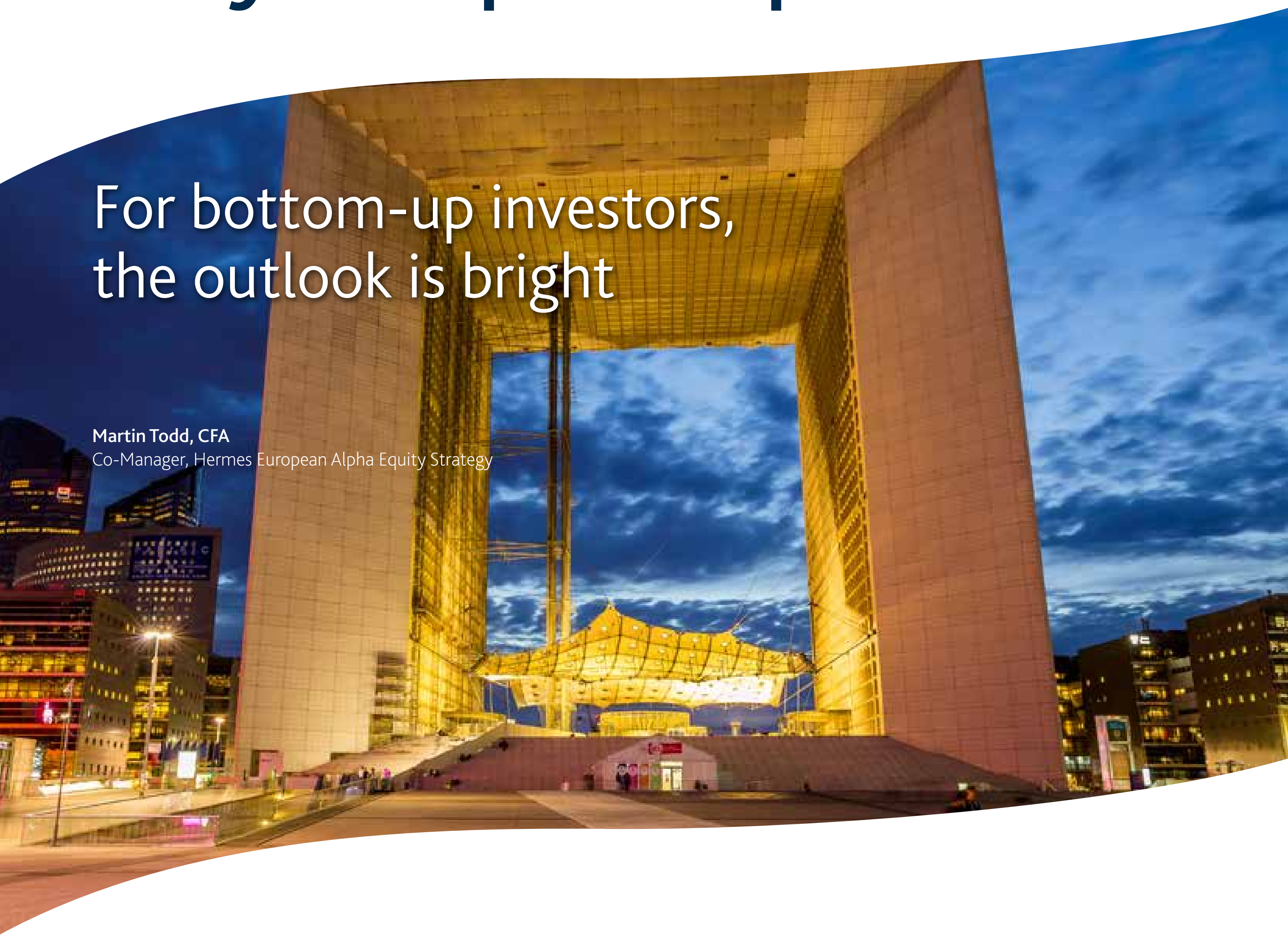


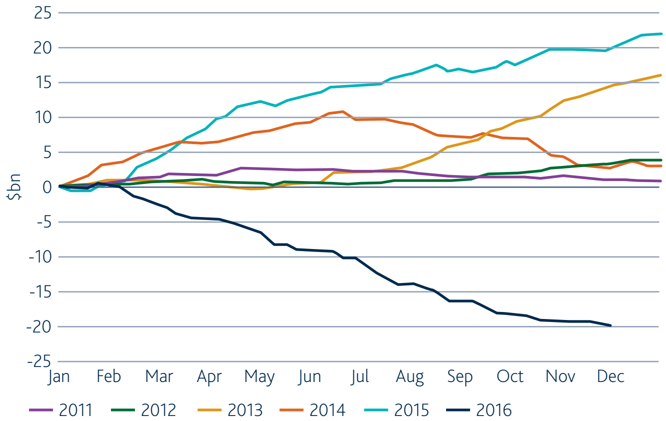
Key points

- Investors have avoided or exited European equities in a year of political shocks and macroeconomic uncertainty
- While the risks posed by far-right parties and instability in Eastern Europe are myriad, their impact on markets may be overblown
- We believe that investors focused on top-down events may be missing out on bottom-up opportunities
- Only active managers can concentrate on the European companies with the financial strength and vision to take control of their destiny

Investors have retreated from European stocks throughout 2016, with market sentiment close to its lowest level since the 2011-2012 sovereign debt crisis. Then, as now, political and macroeconomic uncertainty was the source of their anxiety. Amid continued economic torpor, a range of political pressures – including Brexit, the rise of anti-establishment movements that threaten the European construct, and social tensions caused by the migrant crisis – have spurred investors to pull up to €100bn from active European equity funds this year.

We believe they need to further investigate what is happening on the ground. Companies are not the economy or the politics of any nation, and though European businesses may operate within these overarching forces, many have the talent, resources and opportunities to adapt, restructure and innovate in order to thrive. In the absence of an economic tailwind, successful companies develop value-added products and services, establish efficient cost bases and build robust balance sheets. Investors who are disheartened by political risk miss these opportunities.

Figure 1. Gain drain: US investors spurned European equities in 2016



Source: AMG/Lipper, Goldman Sachs Global Investment Research at December 2016.

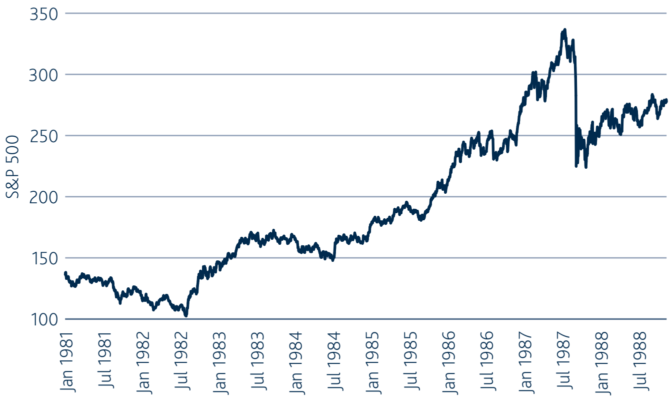
Déjà-vu

This is an argument we know well. In our 2012 commentary, "Why European equities: Crisis brings the greatest opportunities", we argued that the risk-reward trade-off for active investors in the market remained favourable despite the crises dogging the euro zone. "It is in the politics of Europe that the most doubt remains," we wrote, as seemingly insurmountable political and economic risks overshadowed corporate fundamentals. Four years on, we are struck by a strong sense of déjà-vu, heightened by the knowledge that investors concentrating on top-down risks may overlook bottom-up opportunities.

There is no shortage of political flashpoints in Europe. Uncertainty over Brexit will persist, and there are other developments contributing to the perceived European malaise: in French and German general elections this year, right-wing movements risk undermining long-standing liberal establishments; in Turkey, President Recep Tayyip Erdogan's authoritarian grip on society is strengthening; and on the Russia-Ukraine border, conflict smoulders with a constant threat of escalation. Even the corporate tax dispute between Apple and the European Union (EU) in August 2016 had a political whiff to it, not only pitting European and US bureaucrats against each other over retrospective taxes, but also questioning Ireland's tax sovereignty.

It is easy to overestimate the impact of political events though. Investors that predicted the UK's vote for Brexit may have briefly been in the money, but unless they were nimble enough to take profits in the days immediately afterwards they would have subsequently surrendered those gains and more. Many were worried about what the election of Donald Trump meant for markets, but the enthusiastic response from US equity markets confounded the sceptics. While it is too early to tell what a Donald Trump Presidency will bring, it is worth remembering that many investors were fearful when Ronald Reagan, a former Hollywood actor, was unexpectedly elected in 1980. Anyone who sold out of the US equity market at that time would have missed the subsequent doubling of the S&P 500 over his presidency, a period which included Black Monday (see figure 2).

Figure 2. Running to the script of Reagonomics: S&P 500 returns, 1980-1988



Source: Bloomberg as at 31 December 1988.

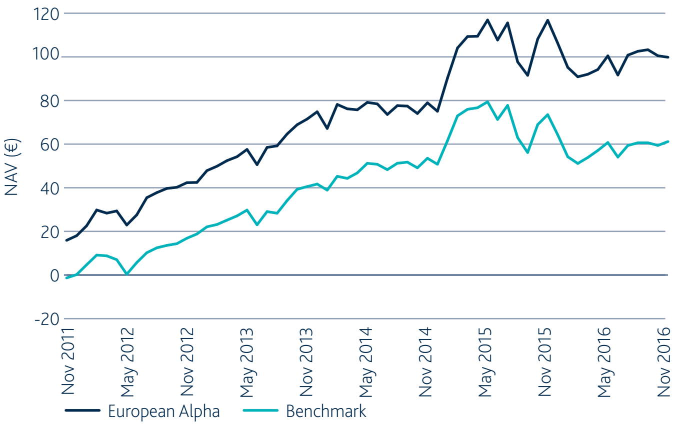
Defying the doomsayers

The political stage is not the market, and the corresponding risk needs to be weighted accordingly. We don't trivialise political risk, but prefer to base our assessment of potential stock performance on analysis of the underlying company. As we stated in 2012:

> It has been important to step back from the endless stream of depressing daily headlines on the depth of the crises in Greece, Ireland or Spain to recognise the strength of franchises and balance sheets within many European companies, which has allowed individual stocks to outperform the local economy and stock market. 'Stock markets are not the economy' is a favourite mantra of ours.

Four years later, it's hard to argue that the economies of Greece, Ireland and Spain have been fixed, but that hasn't stopped the market from performing strongly. Investors whose actions embodied Warren Buffet's advice – "You want to be greedy when others are fearful" –have been rewarded. We are pleased that many of our clients are among them: the assets under management in the Hermes European Alpha Fund have increased every calendar year since inception, and over the past five years it has generated a net annualised return of 10.8% in euro terms for clients.[1]

Figure 3. Performance of the Hermes European Alpha Fund, November 2011-November 2016



Source: Hermes as at 4 January 2017.

Such gains would not have been possible if we saw politics and the economy as equally important as the market. Instead, we focused on identifying opportunities. These included the following portfolio holdings:

Valeo

The automotive technology specialist understood the changes that were necessary in order for it to prevail. Its focus on emissions-reducing car parts was not enough in itself: heavy investment in research and development to defend its status as a top-tier supplier was essential. Diversification, both geographically and across its client base of original equipment manufacturers (OEMs), combined with greater balance-sheet strength and a relentless focus on efficiency were key aspects of its strategy. Valeo's transformation in the past five years has been phenomenal: the company's net income has doubled and its free cash flow has more than tripled, leading to a four-fold increase in its share price.

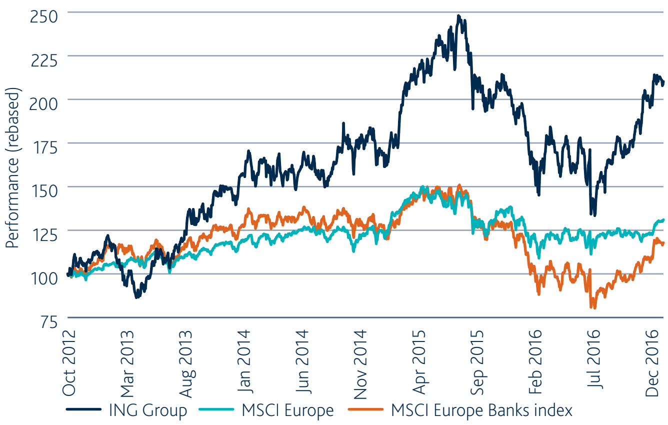
Improved European auto sales provided a tailwind, too. Amid discussion about peak car sales in the US, European car sales have been cruising at a good speed. The delayed recovery in the region's car market after the financial crisis drove the average age of cars on the road to record levels. Only in the last 18 months have car sales accelerated in Europe. Despite talk of autonomous cars and electric vehicles, the market for internal-combustion engines appears to be robust. Nevertheless, greater electric car production can benefit auto-parts suppliers like Valeo or Continental, which earns three times as much on providing components for electric vehicles than for traditional autos.

ING Group

ING has transformed itself from stricken financial services conglomerate (it received a €10bn government bail-out in 2008) to low-cost banking disrupter. Despite low rates crimping interest income by 10% between 2013 and the end of last year, the bank's costs have fallen faster. ING Group lowered savings deposit rates, invested in digital banking and diversified away from low-margin mortgages (which still account for half of its lending) into more profitable products like personal loans. As a result, since 2012 its underlying return on equity (RoE) has almost doubled to 10%, which compares favourably with the single-digit levels of many of its European peers.

ING Group has also vastly reduced leverage, built its Common Equity Tier 1 capital, disposed of non-core assets, reinstated its dividend and grown operating income by 26%. Shrewd management and mitigating actions have more than offset the corrosive effect of low rates on net interest income, while its new cost plan will reduce its cost-to-income ratio to 52%. All of this has led ING to generate a total return that is 62% greater than the MSCI European banks index over the five-year period ending in October 2016.

Figure 4. ING Group's growth is driven by a focused strategy, not an economic tailwind



Source: Bloomberg as at 6 January 2017.

Inditex

Where ING has adapted radically to cope with a changing business environment, Inditex has been able to maintain its pre-eminence in the market in a more subtle manner. It remains the world's largest fashion retailer, growing its like-for-like revenues at more than 5% over the 15 years since it listed. In recent years revenue growth has accelerated further still, despite the company's vast store network and considerable size. In 2015, same store sales were up 8.6% and in the first half of 2016 they were up 11%. Last year, the company's sales growth outperformed its retail peer group by more than 10%. This is largely due to its 'proximity' business model, which supplies products to stores just four weeks after they are designed. Inditex's scale – it generated more than €20bn of revenues in 2016 – doesn't preclude further growth opportunities. For example, its share of the Chinese apparel market is just 0.05%, while in the US it has just 80 stores, and it has a nascent online presence.

Supportive market forces

Having acted to preserve or improve margins in the tough times, many European companies have benefited from central bank policy. Ever since Mario Draghi, the President of the European Central Bank, committed to doing "whatever it takes" to support Europe's economy, the market has been positively surprised by every subsequent update. Quantitative easing in Europe is still in its relative infancy, yet discussions are already progressing towards infrastructure spending and fiscal stimulus. Listed European companies could be well placed to benefit.

[1] Source: Hermes as at 4 January 2016. The stated return is net, annualised and in euro terms for the five years ending 30 November 2016. Past performance is not a reliable indicator of future results..

One of the peculiar outcomes of the ultra-low interest-rate environment is the ability of European companies to issue corporate debt at a negative yield. European multinationals Henkel and Sanofi have respectively issued three- and five-year bonds to the market for which they are earning 5bps. When a company's cost of funding is negative, most things are accretive. Acquisitions, share buy-backs or investment in products, plant and equipment are fairly attractive when they are being subsidised. For years there has been talk of stock buybacks accelerating in Europe – it's hard to know when we'll reach a tipping point, but the potential certainly remains.

Merger and acquisition (M&A) is clearly an option, and we've seen a number of deals recently that would not have been feasible in an environment with higher interest rates. In the last two years, bids have been aimed at portfolio companies BG Group, SAB Miller, ARM Holdings and, most recently, Delta Lloyd. Other holdings, such as Bayer, Gamesa and Deutsche Boerse are currently involved in M&A. In a low-growth world with ultra-low interest rates, more of these kinds of deals look likely.

Despite Brexit, UK companies are still being bid for, and offers for both ARM and UK Mail have been accepted since the EU referendum. In Germany, we see inbound and outbound M&A: 24 German businesses were acquired by Chinese companies in the first half of 2016, at a rate of almost one per week. Of all European transactions, 18.5% originated from China, which conveys the attractiveness of European companies despite the top-down gloom.

Persistent outflows from European stock markets have also improved stock valuations. In December 2016, the MSCI Europe Index traded on a price-to-earnings multiple of 14x for calendar year 2017, according to Bloomberg. The market's enterprise value-to-EBITDA multiple, a method of gauging return on investment, was about 8x and its dividend yield 3.8%. Double-digit earnings growth of between 11%-12% was forecast, indicating that not all investors believe the oppressive macro environment will stymie business growth.

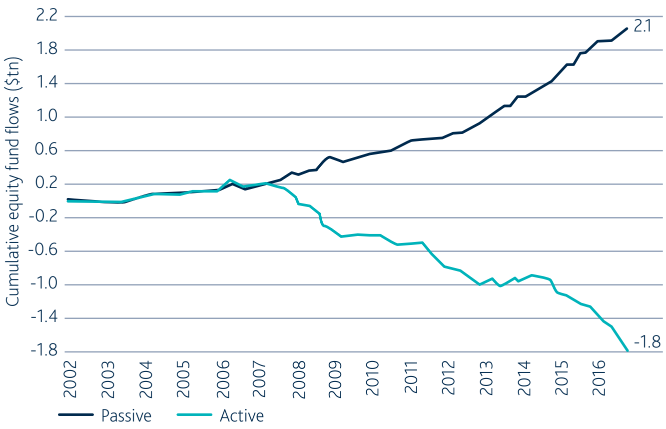
The resilience of active management

We do not rely on a cyclical upturn to lift the stocks we own: we focus on companies that are in control of their destinies, rather than captive to economic forces. This helps us identify growth stories and defend against downside risk should economic growth disappoint or political risk rise, as it did in 2012:

> Another virtue of quality-growth stocks is that they provide downside protection in weak markets. This is an important attribute, and one that has greatly benefited the performance of the Hermes European Alpha strategy. In volatile conditions, preserving capital better than the market in a weak environment for returns, while also participating in rallies, helps build relative outperformance through the power of compounding.

Weak sentiment provides great opportunities for stock-pickers such as ourselves. Our bottom-up approach has served us well, and we believe it will deliver further success in a world where passive equity funds represent more than 20% of the market. A well-informed, active approach allows investors to detect compelling opportunities. In contrast, passive strategies ensure that investors own all of the market's problems.

Figure 5. Passive is getting massive – and it owns the bad with the good



Source: Bank of America Merrill Lynch Global Investment Strategy, EPFR Global as at November 2016.

Choose opportunity

What makes Europe a source of exciting investment opportunities is that the companies which are performing strongly have already endured eight years of economic and political turbulence. Many of investors' current concerns are similar to the anxieties of 2008 and 2012. However we choose to listen to companies' messages of cautious optimism and opportunity rather than economic pessimism. The verse has changed but the song remains the same.

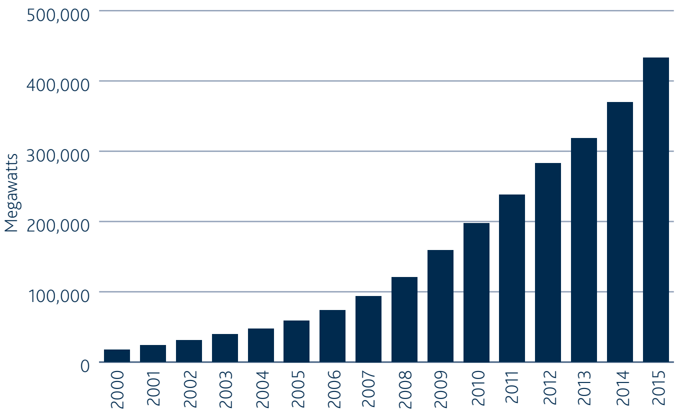
Without an economic tailwind, these companies continue to grow by improving efficiency and reducing costs, primarily through new technology. A prime example is Madrid-based **Amadeus**, an IT solutions provider to the travel industry, whose Altea software enables airlines and hotel companies to manage their capacity, pricing and general costs more effectively. Another is London-based **Autotrader**, an online vehicle classifieds service, which has grown in popularity by lowering marketing costs for car dealerships. In fact, its emergence as the primary portal for used cars has made the second-hand car industry more efficient. Both companies are held in our portfolio.

Technology remains critical for each stock and sector in the market today. Whether it's retailers enhancing their online sales channels, banks overhauling legacy IT systems or mega-cap pharmaceutical companies protecting themselves from cyber threats, it is imperative that companies harness the productivity-enhancing catalyst that is technological change.

The rise of non-cash payments is a clear change in commerce that is being driven by technology. Whether consumers pay by credit card, Paypal or through ApplePay, the facilitator of these transactions is a payment-processing company. We see two of these operators, **WorldPay** and **Wirecard**, as attractive holdings given the clear growth opportunities in this rapidly evolving market. Their earnings are growing at double-digit rates as consumers become increasingly comfortable with mobile payments. Operational leverage is built into their business models, given that fees are a tiny fraction of every transaction, for which there is almost no incremental cost.

Improving technology has also turned around the fortunes of wind turbine manufacturer **Gamesa**, a current holding based in Zamudio, Spain. No longer dependent on subsidies to be cost effective, Gamesa has achieved a level of efficiency that enables it to produce energy at a cost equal to that incurred by competitors drawing on fossil fuels. As a leading onshore wind-energy provider, it was perfectly matched in its recent merger with Siemens' wind power business, which specialises in offshore turbines. Add operational improvements and a growing services arm, plus the heightened importance of energy self-sufficiency and reduced carbon emissions, and it is little wonder that Gamesa has generated a multi-year order pipeline.

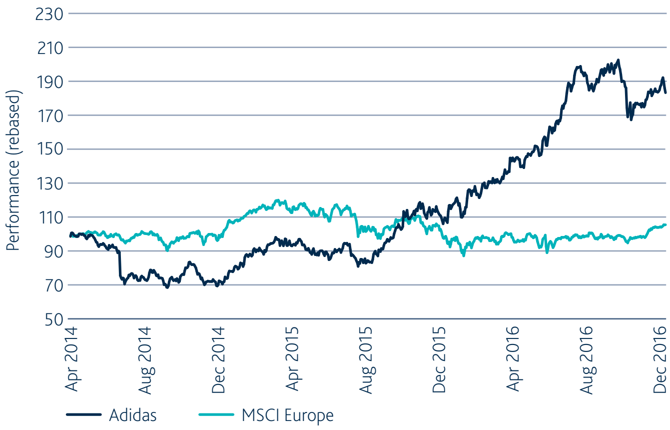
Figure 6. Change in the air: global cumulative installed wind capacity



Source: Global Wind Energy Council as at 31 December 2015.

Progress rarely takes a direct path, and investors must exercise patience in order to capture the growth that its arrival can bring. **Adidas** is one of our long-term holdings, and in mid-2014 our resolve, as shareholders, was tested. Loss of market share in the US, a sub-par golf business and some adverse foreign-exchange movements led to a series of downward revisions and some investor capitulation. We met with the company's management team and concluded that the brand remained firmly intact, and that the majority of issues appeared to be temporary and self-inflicted. The subsequent 24 months saw the stock gain 200%. From double-digit downgrades, it has now experienced double-digit upgrades. Earnings-per-share growth is forecast to be 15% in 2017 and 18% in 2018. For all the scepticism towards European equities, Adidas proves that even a well-known large-cap in this market can almost triple in value in just over two years.

Figure 7. Adidas: finding its stride



Source: Bloomberg as at 6 January 2017.

A bright outlook

It's time to be greedy: as the market focuses on the enduring economic and political problems in Europe, opportunities for other investors to identify resourceful, innovative and growing companies will persist. European society may not overcome its economic and political challenges in the coming years, and outflows from equity markets may continue, but that doesn't concern us. Founded on either economic, political or policy concerns, we see scepticism and fear as signals of opportunity. European companies will continue to adapt over the next four years, forging their own destiny in spite of regional misery. Investors who recognise this will be in the minority, and they will be rewarded.

Excellence. Responsibility. Innovation.

Hermes Investment Management

Hermes Investment Management is focused on delivering superior, sustainable, risk-adjusted returns – responsibly.

Hermes aims to deliver long-term outperformance through active management. Our investment professionals manage equity, fixed income, real estate and alternative portfolios on behalf of a global clientele of institutions and wholesale investors. We are also one of the market leaders in responsible investment advisory services.

Our investment solutions include:

Private markets

International real estate, UK commercial real estate, UK private rental sector real estate, infrastructure and private equity

High active share equities

Asia, global emerging markets, Europe, US, global, and small and mid cap

Credit

Absolute return, global high yield, multi strategy, real estate debt and direct lending

Multi asset

Multi asset inflation

Responsible Investment Services

Corporate engagement, intelligent voting and public policy engagement

Offices

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Why Hermes European Equities?

Alpha generators

We select each stock on its long-term merits, not for its position in an index.

High conviction

Our portfolio contains 30-60 'best ideas' generated from original research. We believe high-conviction, concentrated portfolios are the best equipped to deliver sustainable alpha generation.

Comprehensive risk management

We place great emphasis on balancing alpha generation with protecting investors from overly concentrated sources of market risk. Our approach goes beyond the industry standard, and offers a forward-looking and empirical approach driven by strong research.

Long-term focus

We aim to capitalise on the effects of positive change over time at both company and industry level. We steer away from short-term trading, and our track record is based on a disciplined process developed over many years.

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