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CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENTARY

CURBED ENTHUSIASM

December 2007

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Curbed Enthusiasm

European equities have surprised on the upside in recent years, but they sputtered in 2007, and we are concerned that the stage is set for further disappointments ahead. The MSCI Europe Index squeaked out a return of about 6% in 2007—not far above that of bonds. This is the first year since 2002 that European equity returns have not topped bond returns by a wide margin. Among the questions we will attempt to answer in this brief report: Why such a lackluster result in 2007—what were the bright spots and the lagging sectors? What are the prospects for 2008? And, how can investors best position themselves?

The United Kingdom

Returns from U.K. shares were choppy this year, with the FTSE All-Share returning 5.3% for the full year, after gaining 10.3% during the first ten months of the year, giving up nearly that much during the month of November, and then treading water during the final weeks of the year.

Uneven Distribution

Share price gains were quite lumpy, with shares of commodity-related firms getting touched by Midas, while troubled financial shares underperformed the broad market by more than 19%. Materials shares within the broad FTSE All-Share Index, in fact, contributed more than half of the index's gains for the year, despite making up only 6.8% of the index a year ago (Table A). Shares of mining firms such as Rio Tinto and BHP Billiton soared, as spot prices of precious metals reflected inflationary and monetary concerns, together with a global commodity fervor. Energy shares, which accounted for about 14.5% of the index, returned 23.6%, contributing 3.1 percentage points of the index's 5.3% return (they underperformed energy shares globally by about 2 percentage points, though). Financial shares suffered during the year, as exposure to poorly underwritten U.S. subprime residential mortgages showed the downside of a relatively borderless investment landscape and Northern Rock suffered a true run on the bank.

U.K. large-caps outperformed small caps by a wide margin; the first year of large-cap outperformance since 2002. The total return of the FTSE 100 exceeded that of the FTSE 250 by nearly 10 percentage points, and exceeded the FTSE SmallCap's return by 18 percentage points. This trend echoed the pattern seen in the United States and in continental Europe in 2007, and in part also reflects an increasing investor preference for firms with lower debt.[1] The largest 15 firms in the FTSE All-Share, according to Morgan Stanley, have net debt levels around one-quarter of their equity levels, compared to about 70% for the 16th through 100th largest stocks in the U.K. equity universe and 110% for the smaller remaining shares in the universe.

[1] Graham Secker of Morgan Stanley reported in his December 6, 2007, *UK Strategy* report that a strategy of going long the shares of the quintile of firms with the highest net-debt-to-equity ratios and going short the least-indebted firms resulted in a -18% return for the year through early December.

Once the year is tallied, earnings per share (EPS) growth for 2007 is expected to be modest, as large write-offs plague financial firms. Consensus estimates in mid-December pegged nominal year-on-year growth for 2007 to come in at 5.2%; after inflation adjustments, EPS growth was almost dead even with the year's estimated real GDP growth of approximately 3%. Earnings growth was by no means extreme, but the steady rise above its long-term trendline continues both to impress and to sow further doubts about sustainability (Table B).

Return-on-equity (ROE), at 19.8% according to the latest data for 2007, seems to have topped out, but remains near its record level and nearly 2 standard deviations above its average level over the past three-plus decades (Table C).[2] According to Morgan Stanley, the market's ROE is notably higher than that of the median stock in the index, and that median stock's current ROE is only about average compared with its long-term trend. Consensus analyst expectations for both 2008 and 2009 anticipate market ROEs above 16% (the consensus estimate for 2007 is 16%).

Expectations May Not Be Reasonable

Valuations were little changed over the course of 2007, as earnings growth more than kept up with the year's share-price gains. The standard price-earnings (P/E) ratio appears reasonable, with shares priced at 12 times trailing annual earnings. However, P/E ratio variants that adjust for the cyclicality of earnings and profitability diverge sharply from that standard ratio. Shares are 18 times their average real earnings over the past decade, and 17.1 times the profits that companies would theoretically have earned in 2007 if ROE levels declined to their historical average (Table D). If earnings slip off the treadmill, returns will disappoint, even absent any margin compression.[3] Other valuation metrics present a picture of a market with prices that are elevated, but that are in keeping with the rest of the developed world (Tables E and F).

The story of 2007 for owners of U.K. equities was not primarily about the Bank of England's Autumn interest rate cut, nor about the beleaguered U.K. property sector,[4] but rather was more reflective of homebuyers in California mailing their keys to their mortgage lender, Chinese builders paying record prices for copper wiring, and Canadian workers extracting oil from Alberta's tar sand deposits. Which sectors are tapped to lead in 2008? Analysts are expecting strong EPS growth again from materials and energy stocks of 14.4% and 10.2%, respectively, based on consensus I/B/E/S analyst forecasts. Health care firms, suppliers of consumer staples, retailers, and grocers are also expected to deliver double-digit EPS growth. If slowing U.S. and European economies eventually dampen emerging markets commodity demand, then the domestic consumer may have to step up spending, home price concerns be damned, or overall earnings growth will disappoint.

[2] The 20% level shown currently for 2007 seems likely to fall, once financial firms' third- and fourth-quarter credit-related write-offs have been worked through the system.
[3] Given the optimistic consensus expectation of 16%+ ROE and 8% EPS growth for both 2008 and 2009, margin compression is also possible if earnings disappoint.
[4] Barclays Capital's Tim Bond noted in his December 19, 2007 report, *Bleak Futures*, that the U.K. property derivatives market is discounting a 15% fall in residential property prices in the next three years and a 30% fall in commercial prices over the same period.

Europe ex U.K.

Continental European shares returned almost 6% for the year, below their long-run historical average, but above the return of bonds. Meanwhile, large caps beat small caps. Country returns varied from Finland's 34% to Ireland's -28%.

The Sector Story

Banking sector and diversified financials shares returned -4% and -15%, respectively, as several European banks ended up holding the subprime mortgage bag in one form or another, including exposure to the troubled market for paper issued by structured investment vehicles.[5] Materials shares gained 17%—a major contributor to the MSCI Europe ex U.K. Index's overall return, given the sector's 8% weighting. As slowdown concerns loomed, some non-cyclical consumer sectors did quite well, including food and staples retailers; food, beverage, and tobacco producers; and household products firms—each of which returned 14% or more.

Not as Cheap as a Euro-Funded Shopping Trip to New York City

European shares are priced at 14 times trailing 12-month earnings, 23 times the average annual real earnings over the past decade, and 21 times ROE-adjusted earnings (Table G). Other valuation metrics (Tables H and I) indicate that valuations are perhaps a bit rich but not terribly so, on both an absolute and a relative basis. It is perhaps worth noting, though, that the valuations of the median stock in the MSCI Europe Index are considerably richer than those of the index in aggregate, indicating that larger-cap stocks are a better bargain.[6] Earnings are massively above their historical trendline, having more than tripled on an inflation-adjusted basis since 2002 (Table J). Earnings growth has been decelerating since 2004 (Table K), and consensus analyst expectations for continental Europe are indicating 2007 EPS growth of 6.9%. ROE, estimated at 15.1% for the year, remains near its historical peak.

For 2008, 23 of the 24 industry groups of the MSCI Europe Index are expected to post EPS gains, according to consensus analyst estimates. These analysts, on a bottom-up basis, are expecting the overall index's EPS growth for 2008 to be 10.8%, compared with 6.3% projected growth in 2007. The predicted acceleration in 2008 seems unlikely, given the triple headwinds of a slowing economy (2.0% GDP growth expected for 2008, compared with 2.6% in 2007 and 2.9% in 2006), strong euro, and high producer prices.

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[5] J.P. Morgan estimates that European banks, brokers, and insurers will have written off $46 billion related to the credit crisis by the end of first quarter 2008, with additional charge-offs from activities including commercial real estate and consumer lending to hit later in the year.

[6] Morgan Stanley's January 2, 2008 *European Equity Strategy Quarterly Data Sheet* notes that the aggregate P/E of the MSCI Europe Index is 13.2, while the P/E or the index's median share is 15.4. Price-to-cash-earnings is 9.5 for the index versus 10.3 for the median stock (only 12% of the time has the median European share been more expensive than its current level going back over 22 years). Finally, the dividend yield for the index is 3.0%, but only 2.2% for the median stock.

The Economic Snapshot

The European Central Bank (ECB) has a rock-strewn channel to navigate. Economic growth is slowing and faces threats from U.S. weakness. A cut in European policy rates[7] would probably steer the euro lower, helping exporters, but inflation is already well outside the bank's comfort zone, *despite* the strong-euro tailwind (headline inflation was 3.1% in December, versus a targeted 2% rate), giving the ECB pause.

How much of a threat to continental Europe's real economy would a U.S. recession present? Only 13% of exports from the euro area go directly to the United States; moreover, those exports shrank by 2% during the first nine months of 2007 compared to the same period in 2006, so a further slowdown would not seem to constitute much of a threat to the economy and earnings on the margins. While U.S. export demand is the most direct link, it is not Europe's only exposure to the health of the United States. To answer the question—how dangerous is a U.S. recession to Europe—we must first answer a more difficult question: how tightly linked are the emerging economies and the U.S. economy? Four emerging markets, China, the Czech Republic, Poland, and Russia, together account for 16% of European exports. Exports to those four countries grew by 19% and *accounted for nearly one-third of the growth in European exports* for the first nine months of 2007 compared with the prior year period. We tend to believe that meaningful "decoupling" is unlikely,[8] and that the emerging world remains highly vulnerable to a U.S. slowdown or shock—the likelihood of risk-capital flight from the emerging world in a developed world crisis has not abated.

In addition, the buoyancy that mergers and acquisitions provided to the European market over the past several years has certainly diminished. The pace of private equity transactions is not likely to pick back up soon, with three-month Euribor at nearly 5% and high-yield loans and bonds much higher than that. Strategic transactions may continue, but given debt costs, those may be limited to large acquirers with pristine balance sheets.

The Bottom Line

We are not expecting the sky to fall on the shareholders of continental European or U.K. firms, but we are also not anticipating particularly strong returns in the near future. The quality tilt that we have advocated in the United States has similar merit in Europe. Firms that have global exposure, low debt, and dependable earnings streams performed solidly in 2007, and we believe that they are still well positioned for the coming year.

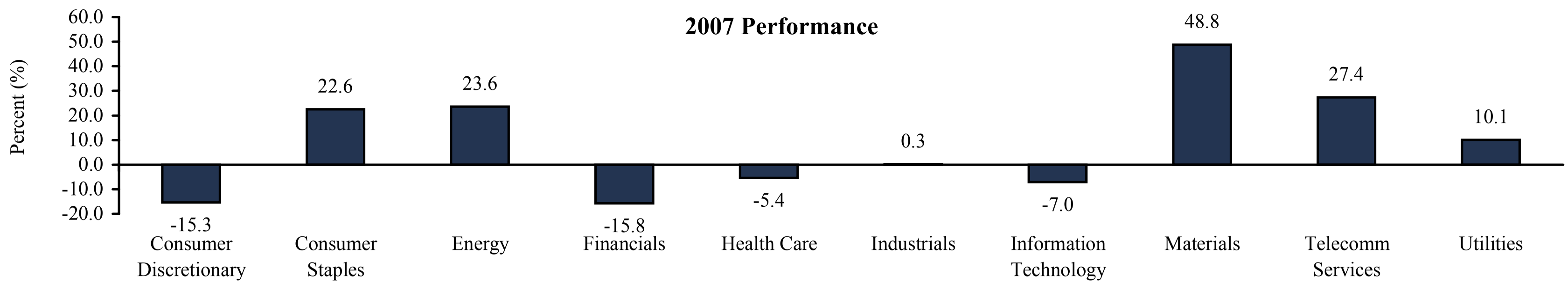
[7] The ECB certainly did not signal a likelihood of imminent rate cuts on January 10, noting that "in a context of very vigorous money and credit growth, our assessment of upside risks to price stability has been fully confirmed."
[8] Please see our October 2006 and November 2007 Market Commentaries, respectively, *Decoupling?* and *Emerging Markets: What To Do, What To Do….*

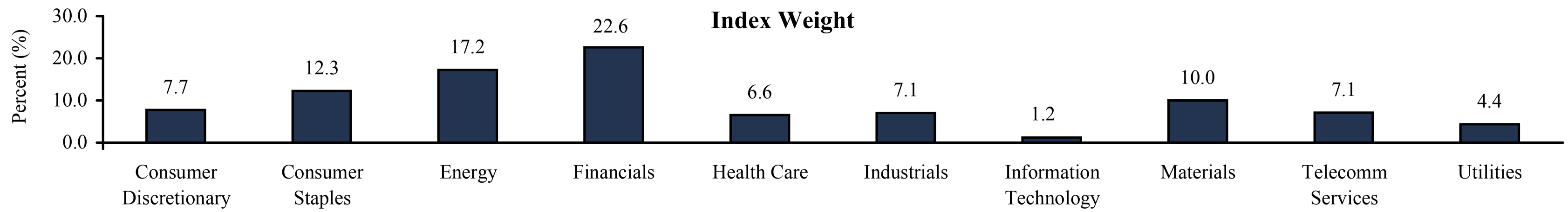
Table A

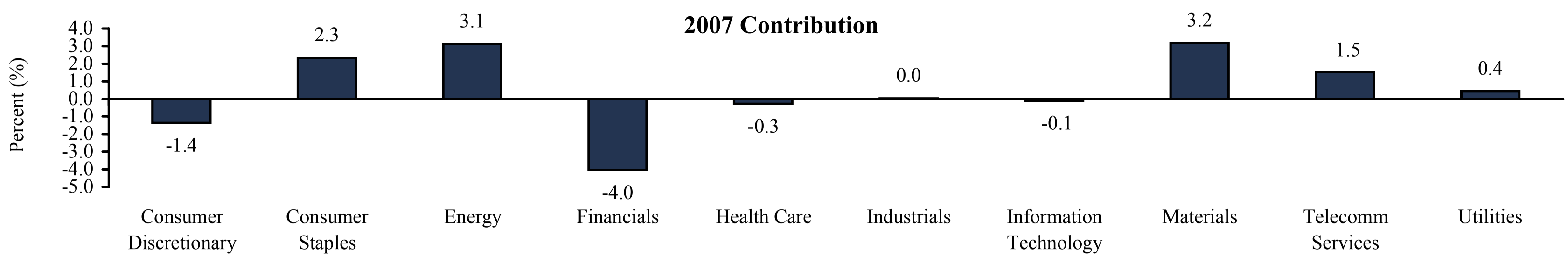
FTSE ALL-SHARE ECONOMIC GROUP WEIGHTS AND CONTRIBUTION

As of 31 December 2007

Local Currency







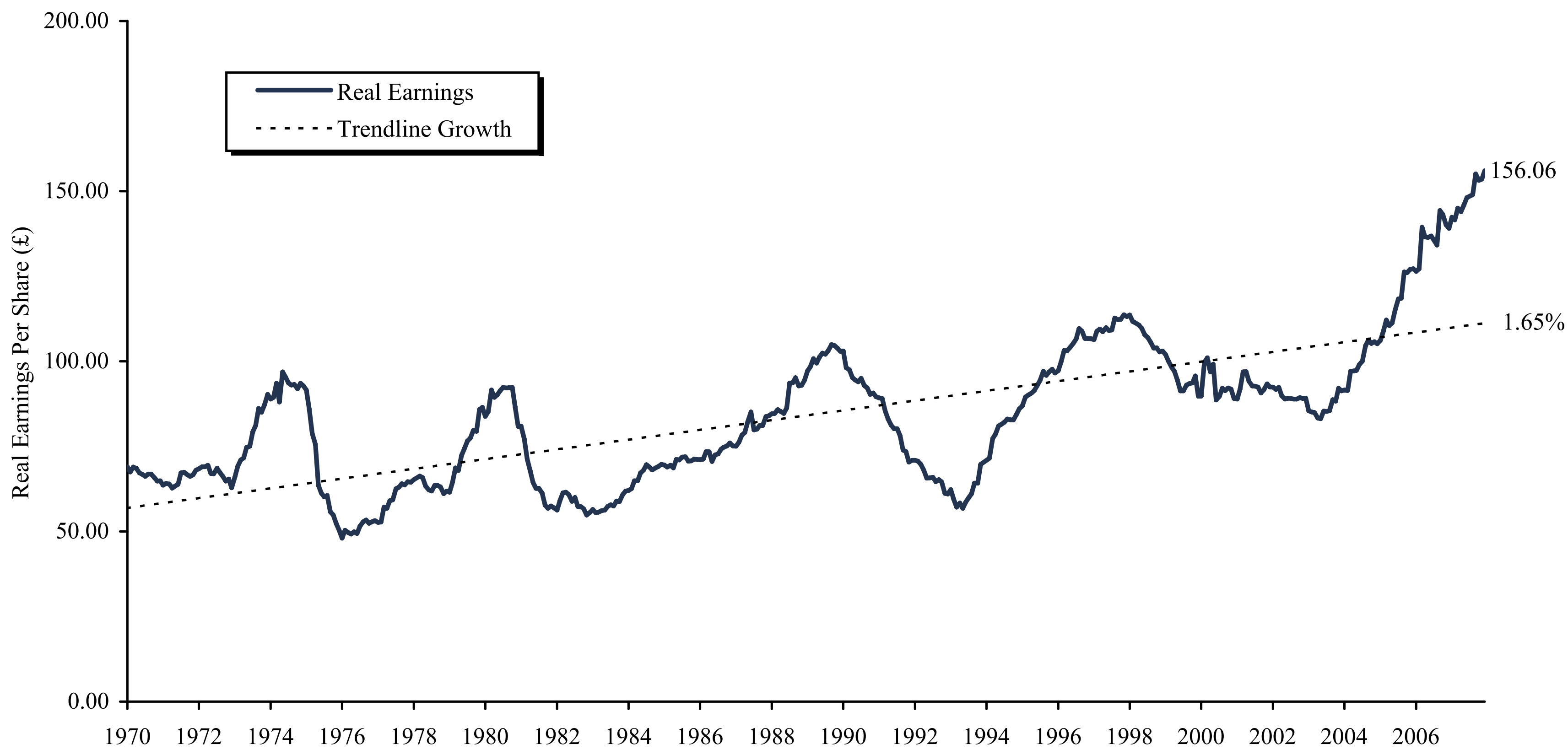
Sources: FactSet Research Systems, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Weights may not total to 100% due to rounding. Approximately 3.8% of the index (accounting for 48 bps of the index's return contribution) is not assigned to any industrial sector and is therefore not shown in this exhibit.

Table B

MSCI U.K. REAL REPORTED EARNINGS

1 January 1970 – 31 December 2007



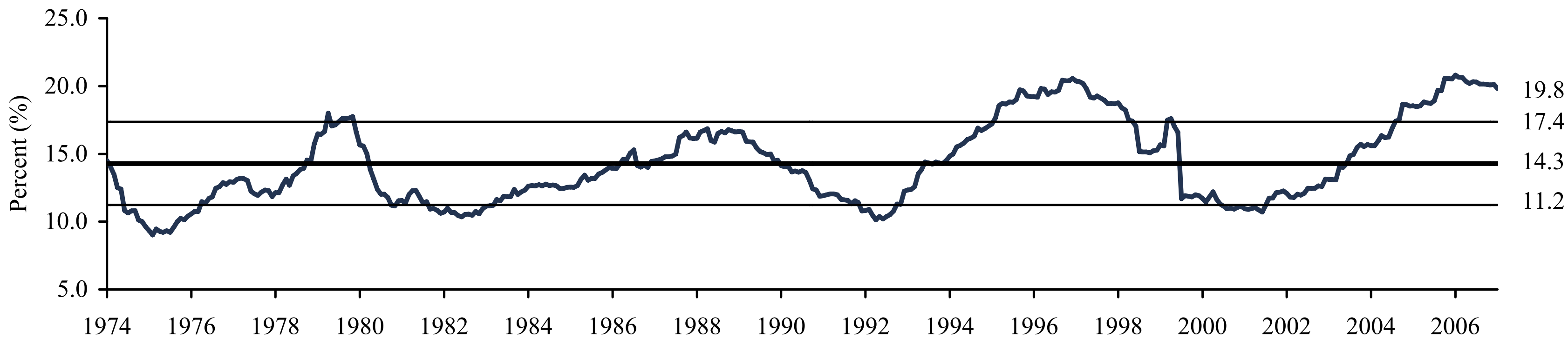
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: The average year-over-year real earnings growth rate of 3.5% is calculated arithmetically. U.K. CPI inflation data are as of 30 November 2007. U.K. inflation data are represented by the U.K. RPI until November 2003 and the U.K. CPI from December 2003 to the present.

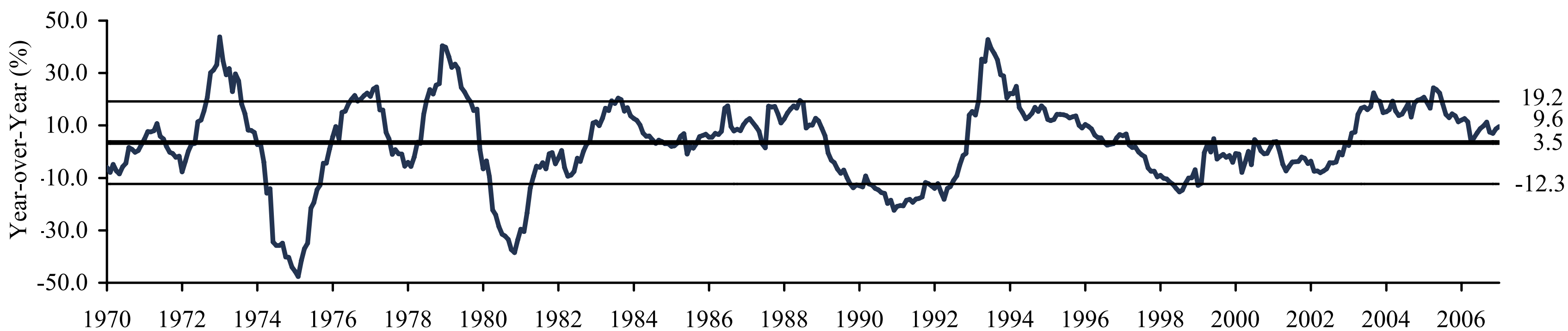
Table C

MSCI U.K. RETURN ON EQUITY AND REAL EARNINGS GROWTH

Return on Equity
31 December 1974 – 31 December 2007



Real Earnings Growth
31 December 1970 – 31 December 2007



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

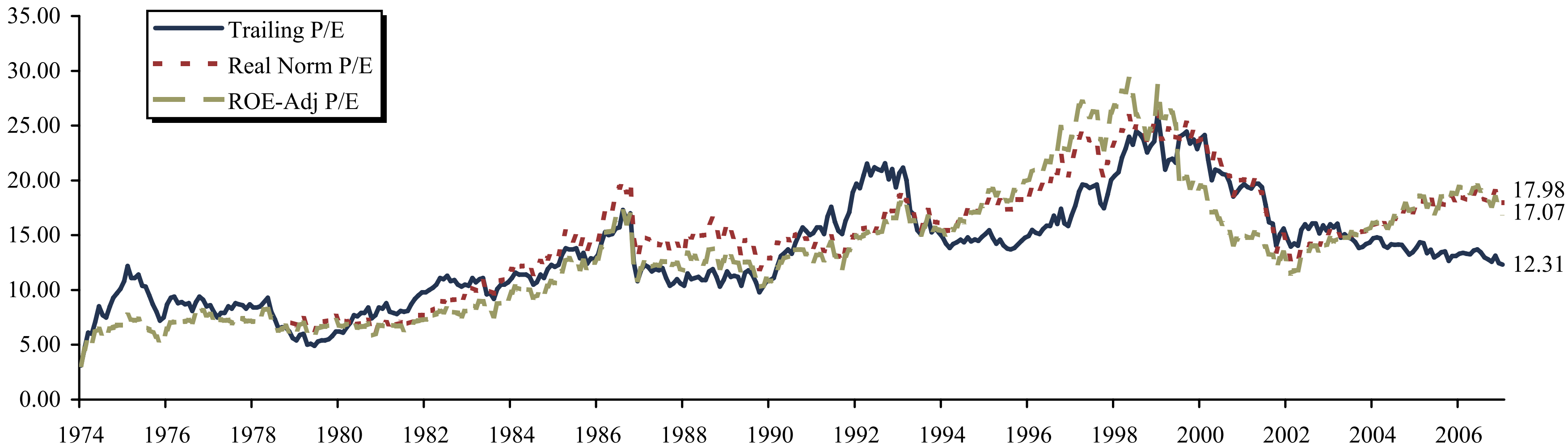
Notes: U.K. CPI inflation data are as of 30 November 2007. U.K. inflation data are represented by the U.K. RPI until November 2003 and the U.K. CPI from December 2003 to the present.

Table D

PRICE-EARNINGS RATIOS USING VARIOUS EARNINGS DEFINITIONS

MSCI United Kingdom

31 December 1974 – 31 December 2007



P/E Ratios - By Types of Earnings

	Trailing 12 Months Reported	Trailing 10 Years Real Normalized	ROE-Adjusted
31 December 2007	12.31	17.98	17.07
Common Period Mean	14.31	15.54	14.71
Std Dev Above/Below Mean	-0.45	0.51	0.44

Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Normalized real price-earnings (P/E) ratios are calculated by dividing the current real index value by the annualized average real earnings for the trailing ten years. U.K. CPI inflation data are as of 30 November 2007. U.K. inflation data are represented by the U.K. RPI until November 2003 and the U.K. CPI from December 2003 to the present. Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its P/E ratio. The ROE-adjusted P/E ratio is the current P/E based on trailing 12-month earnings multiplied by the ratio of the current ROE to its post-1974 average. Common period represents data from 30 November 1979 onward.

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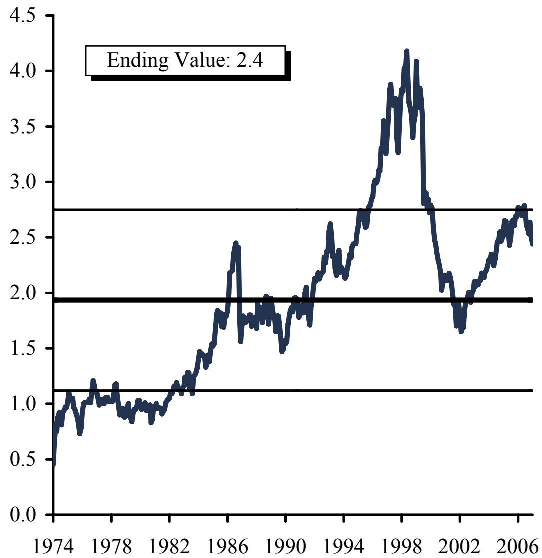
Table E

MSCI UNITED KINGDOM INDEX

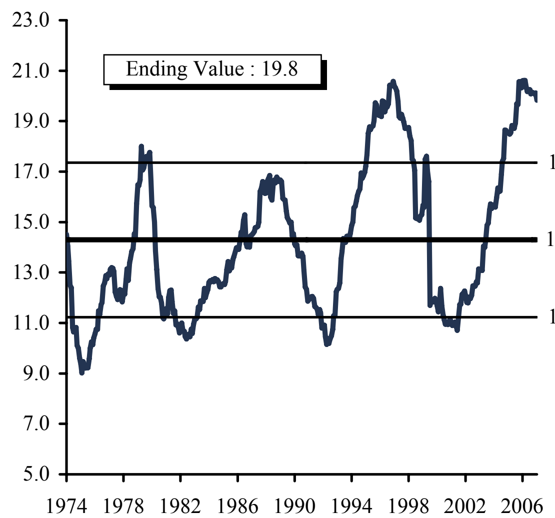
31 December 1974 – 31 December 2007

Price-to-Book Value

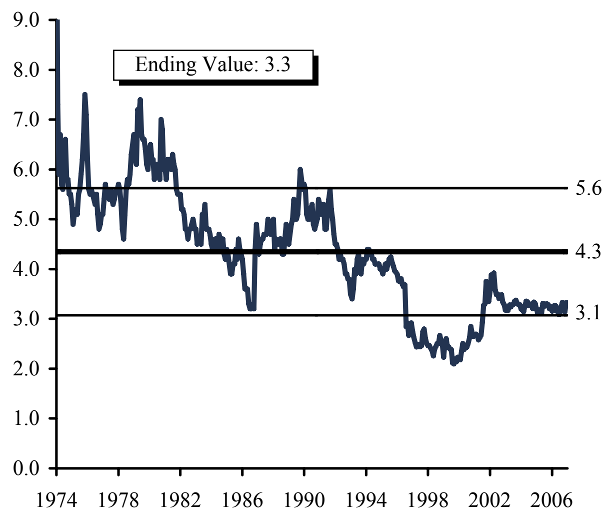


Price-to-Cash Earnings

Return on Equity (%)



Dividend Yield (%)



Mean
One Standard Deviation

Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

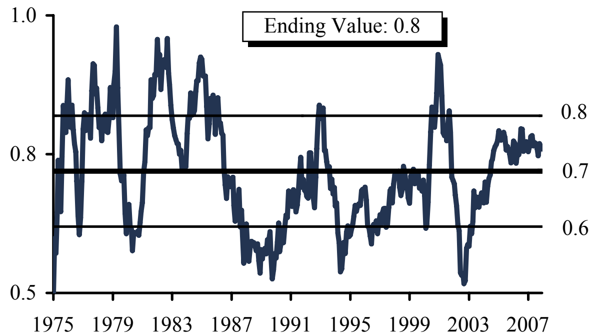
Note: Return on equity is calculated by dividing the index's price-to-book value ratio by its price-earnings ratio.

Table F

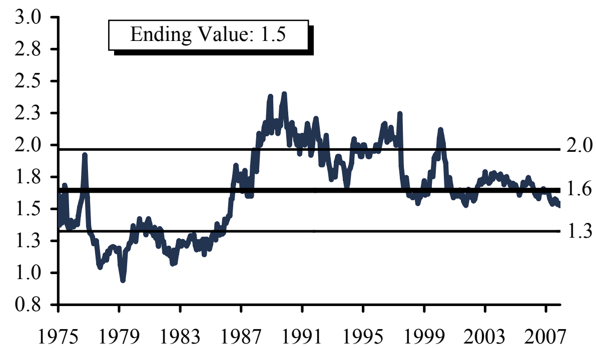
MSCI U.K. RELATIVE TO MSCI WORLD EX U.K.

31 January 1975 – 31 December 2007

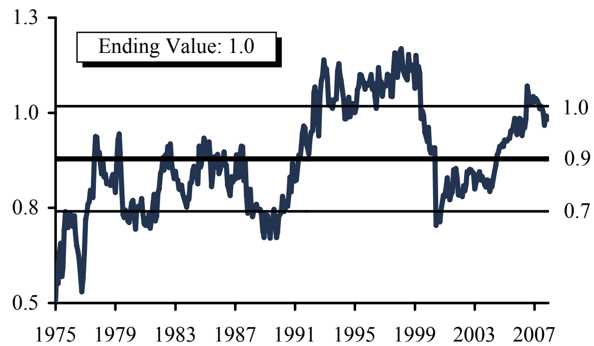
Price-Earnings



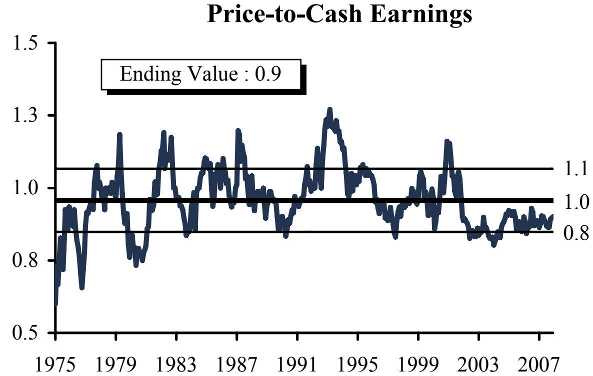
Dividend Yield (%)



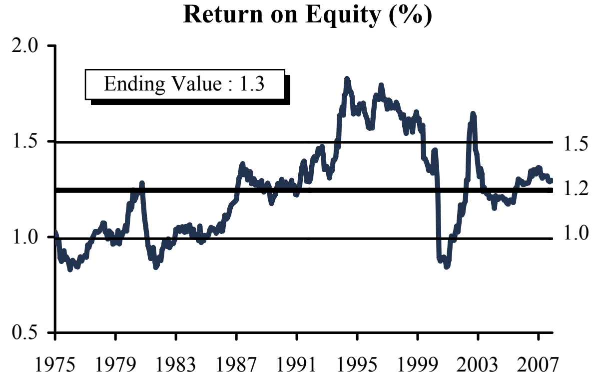
Price-to-Book Value



Price-to-Cash Earnings



Return on Equity (%)



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

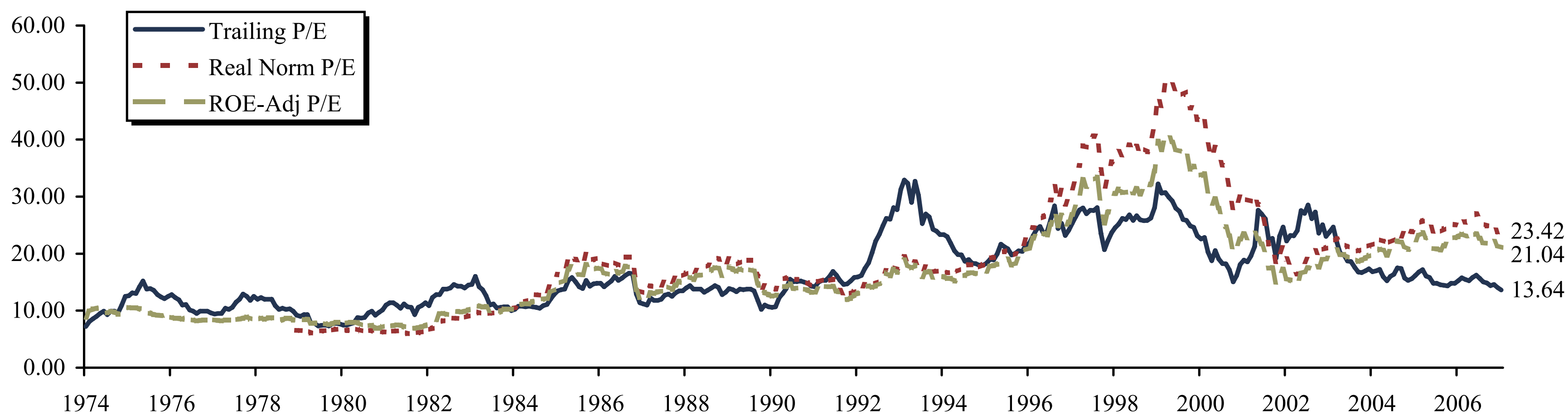
Note: Return on equity is calculated by dividing the index's price-to-book ratio by its price-earnings ratio.

Table G

PRICE-EARNINGS RATIOS USING VARIOUS EARNINGS DEFINITIONS

MSCI Europe ex U.K.

31 December 1974 – 31 December 2007



P/E Ratios – By Types of Earnings

	Trailing 12 Months Reported	Trailing 10 Years Real Normalized	ROE-Adjusted
31 December 2007	13.64	23.42	21.04
Common Period Mean	17.43	19.97	17.81
Std Dev Above/Below Mean	-0.62	0.34	0.44

Sources: Global Financial Data, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Normalized real price-earnings ratios (P/E) are calculated by dividing the current real index value by the annualized average real earnings for the trailing ten years. Inflation data are through November 30, 2007. Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its P/E ratio. The ROE-adjusted P/E ratio is the current P/E based on trailing 12-month earnings multiplied by the ratio of the current ROE to its post-1974 average. Common period represents data from 30 November 1979 onward.
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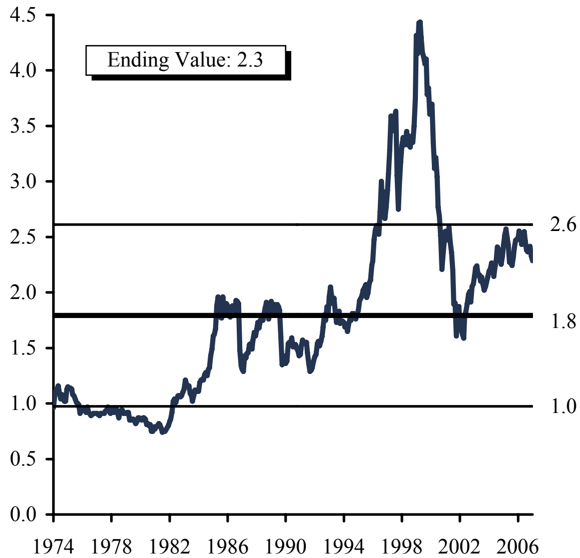
Table H

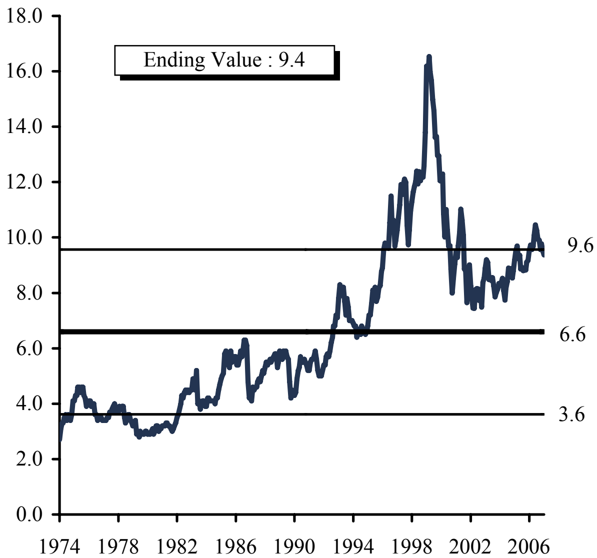
MSCI EUROPE EX U.K. INDEX

31 December 1974 – 31 December 2007

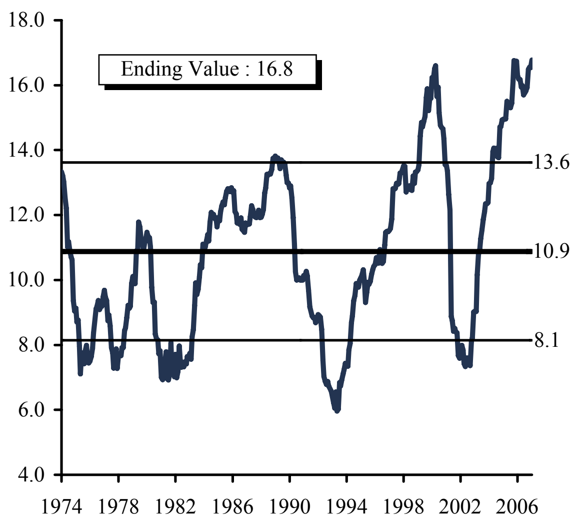
Price-to-Book Value



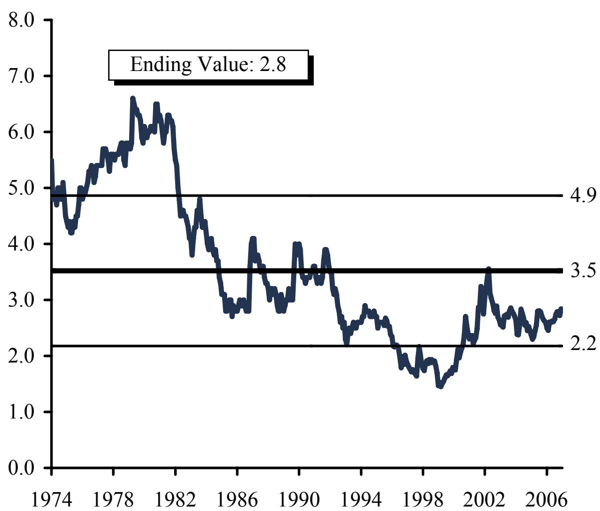
Price-to-Cash Earnings



Return on Equity (%)



Dividend Yield (%)



Mean
One Standard Deviation

Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

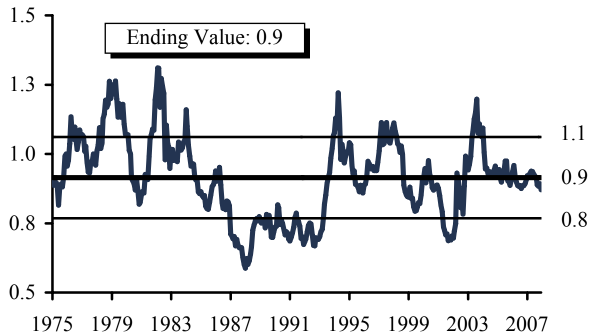
Note: Return on equity is calculated by dividing the index's price-to-book value ratio by its price-earnings ratio.

Table I

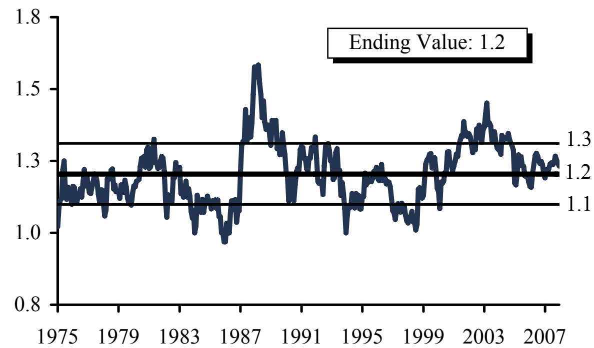
MSCI EUROPE EX U.K. RELATIVE TO MSCI WORLD

31 January 1975 – 31 December 2007

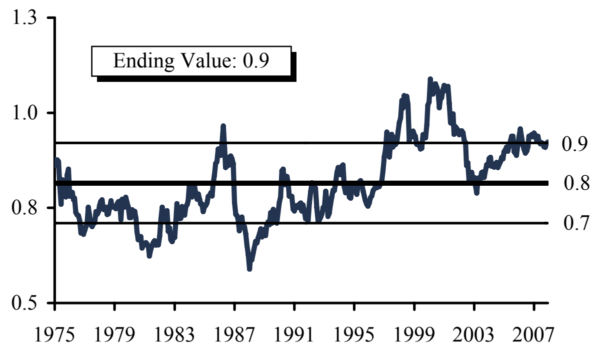
Price-Earnings



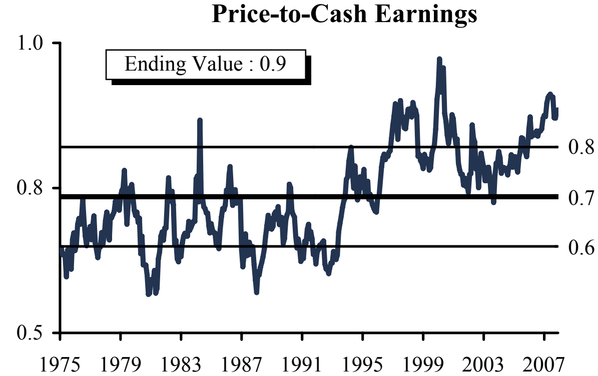
Dividend Yield (%)



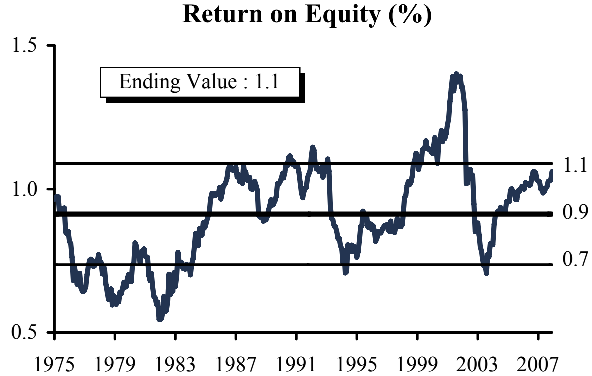
Price-to-Book Value



Price-to-Cash Earnings



Return on Equity (%)



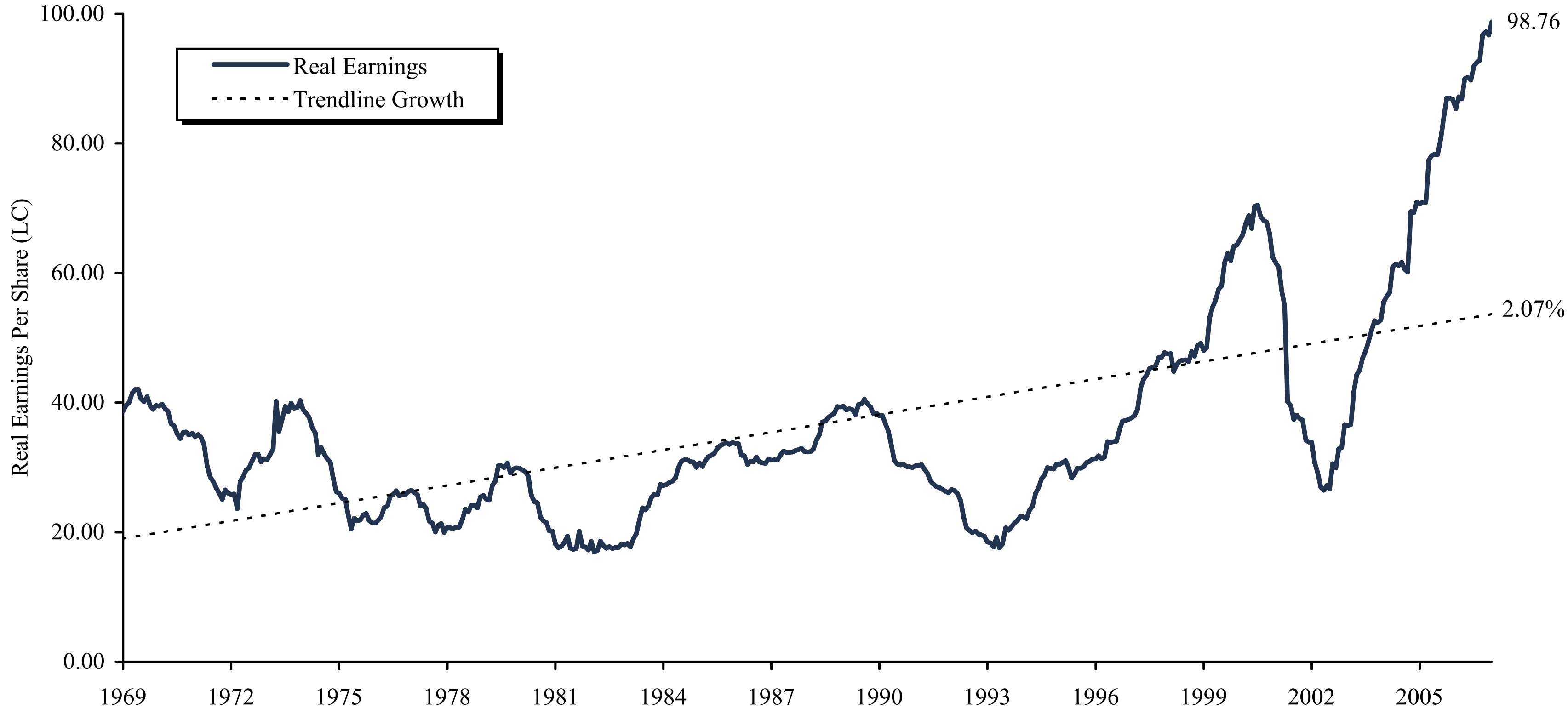
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: Return on equity is calculated by dividing the index's price-to-book ratio by its price-earnings ratio.

Table J

MSCI EUROPE EX U.K. REAL REPORTED EARNINGS

31 December 1969 – 31 December 2007



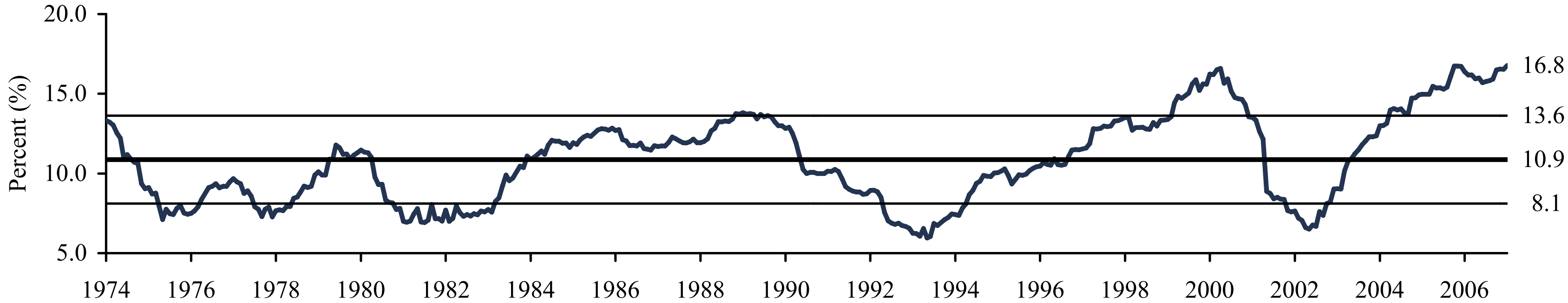
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Data are in local currency. Reported earnings include goodwill amortization. Real earnings are based on Eurozone CPI as of 30 November 2007. The average year-over-year real earnings growth rate of 5.2% is calculated arithmetically.

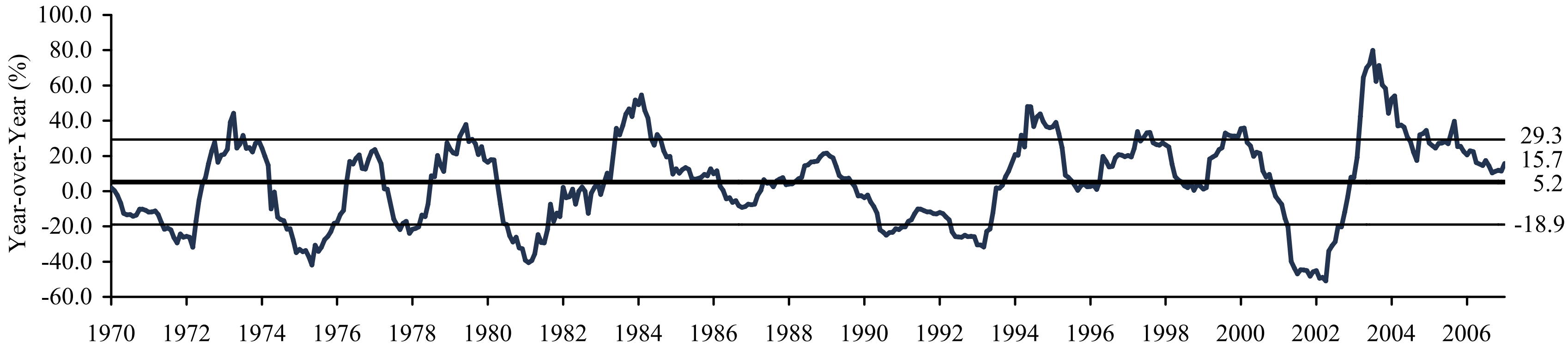
Table K

MSCI EUROPE EX U.K. RETURN ON EQUITY AND REAL EARNINGS GROWTH

Return on Equity
31 December 1974 – 31 December 2007



Real Earnings Growth
31 December 1970 – 31 December 2007



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: Earnings are in local currency and deflated by Eurozone CPI.