



C A M B R I D G E A S S O C I A T E S L L C

EUROPEAN MARKET COMMENTARY

EUROPEAN EQUITIES GETTING PRICEY

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European Equities Getting Pricey

While standard valuation metrics other than price-earnings ratios (P/Es) suggest European equities are somewhat expensive, P/E ratios based on 12-month trailing earnings have remained reasonable, as earnings growth has kept up with European equity's break-neck pace since these markets began accelerating from their most recent lows in March 2003. The MSCI U.K. Index P/E ratio of 14.3 is slightly above its long-term mean of 13.5 and its price-to-cash earnings ratio (P/CE) of 10.0 is modestly above its mean of 8.3. However, the index's price-book ratio (P/B) and dividend yield (DY) are now nearly 1 standard deviation more expensive than they have been on average since 1974. Similarly, Europe ex U.K. equities appear fairly valued on the basis of P/E ratios, as the P/E of 17.2 is only slightly ahead of its post-1974 average of 16.5, though the average itself is high, reflective the generally lofty valuations experienced since the mid-1990s. However, P/CE, DYs, and P/B value are all roughly 1 standard deviation more expensive than their post-1974 averages (Tables A and B).

Why are P/E ratios indicating fair value, when other metrics suggest these markets are rich? Given that earnings in both the United Kingdom and continental Europe have been growing at a rapid pace over the last several years, and that the return on equity (ROE) in these markets is quite high, traditional P/E metrics implicitly assume that this high level of earnings will continue into the future. Normalized P/E ratios that adjust for earnings cyclicality provide a more meaningful measure, and today suggest that these markets are quite a bit more expensive than do standard P/E metrics.

Earnings Strength

U.K. earnings have been on a tear since bottoming at the end of May 2003, with MSCI U.K. Index earnings growing a cumulative 59.9%, or 18.6% on an average annual compound basis, compared to an 8.6% annual rate since our data begin in 1970. At the same time, the ROE for U.K. equities has increased from a cyclical low of 10.9 on September 30, 2001 to 18.5% at the end of February 2006. While the current ROE is not necessarily at its peak, history suggests that it does not have much room to run. Since 1974, the ROE on U.K. equities has averaged 14.0%, which is high by historical standards,¹ and has peaked three times: at 18.0% on March 31, 1980, 16.8% on March 31, 1989, and 20.6% on November 30, 1997.

Earnings growth on the Continent has been even more spectacular. Earnings have grown a cumulative 150.4% since their recent low at the end of April 2003, or an average annual compound rate of 38.3%; well over the 6.4% average rate since 1970. Similarly, the MSCI Europe ex U.K. Index ROE was 15.0% at the end of February 2006, well above its 10.6% post-1974 average, and comparable to previous peaks, exceeded only by its most recent peak of 16.6 experienced in early 2001. Given the high level of earnings growth and ROE, evaluating P/E ratios on a normalized basis, accounting for this cyclicality, is particularly important today.

¹ The long-term average ROE is generally assumed to be about 12%, which is in line with the long-term average for the U.S. equity market (S&P 500 from 1963, when our data begin, through present), and according to Warren Buffet in his famous 1977 *Fortune* article, is the average ROE for U.S. equities for every decade this century through 1975.

Normalized P/Es Suggest Equities are Slightly Expensive

We normalized earnings in two ways in order to adjust for cyclicalities. First, we looked at the normalized real P/E ratio, more commonly known as the Shiller P/E,² in which earnings and market prices are adjusted for inflation to reflect today's values and earnings reflect their trailing ten-year average. Second, we looked at an ROE-adjusted P/E ratio, following a methodology used by Morgan Stanley, in which the current P/E based on trailing 12-month earnings is multiplied by the ratio of the current ROE to its post-1974 average.

While the U.K. market P/E based on trailing 12-month earnings was only 14.3 as of the end of February 2006, the normalized real P/E was 18.2 and the ROE-adjusted P/E, 18.9. Similarly, the P/E for Europe ex U.K. equities increased from 17.2 based on trailing 12-month earnings to 25.6 based on normalized real earnings and 24.3 based on ROE-adjusted earnings. In both markets, the two normalized P/Es have been highly correlated over time, periodically diverging from the unadjusted P/E (Tables C and D).

In order to determine whether P/E ratios based on normalized earnings are more predictive of subsequent returns than are P/Es based on trailing 12-month earnings, we evaluated the relationship between beginning period P/E ratios by these various measures and subsequent five-year returns. While we recognize the data are limited, since MSCI earnings data begin in 1970, and the real normalized P/E metric requires ten years of trailing data, leaving only five discrete five-year periods to analyze, normalized measures produced meaningfully superior results than did the traditional P/E measures. Of course, there were still periods in which high P/Es were followed by high returns, and vice versa, but this occurred less frequently when normalized P/Es were utilized (Tables E and F). We repeated this analysis using the FTSE All-Share for which we have earnings data dating back to 1963 and found similar results (Tables G and H).

Conclusion

Evaluation of P/Es on a normalized basis provides unambiguous evidence that European equities are overvalued. While U.K. equities are slightly expensive on the whole, the high DY and generally favorable valuations relative to those of U.S. and continental European equities should provide some cushion against a potential downturn in global markets, as well as the potential to outperform if conditions remain accommodative. U.K. equities offer a relatively attractive DY of 3.2% (closer to 4% including buybacks), which may be low relative to yields paid out prior to the mid-1990s, but is well above those of other major developed markets regions, as demonstrated by the 2.0% DY of the MSCI World Index. Europe ex U.K. equities are priced comparably to U.S. equities, with both markets more expensive than the other major developed markets regions. From a long-term perspective, we remain enthusiastic about continental Europe, as we continue to believe the market is pricing in low expectations for improvements in labor flexibility, restructuring, and deepening and broadening capital markets, even as the largest countries (Germany, France, and Italy) have made notable improvements. However, for the moment, market prices have gotten ahead of fundamentals.

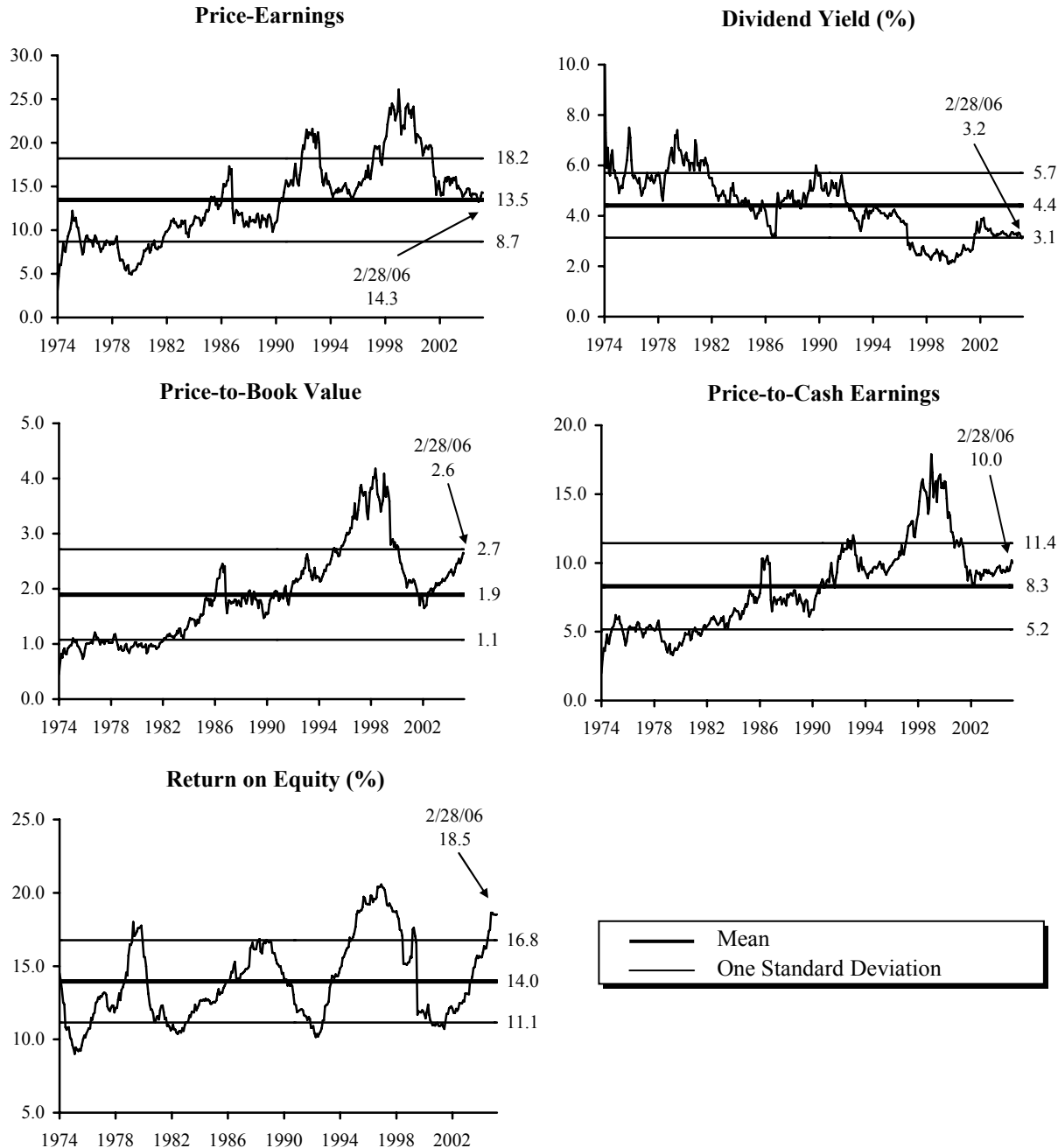
² This measure is named after its developer, Yale professor Robert Shiller.

Table A

GLOBAL EQUITY MARKET VALUATIONS

MSCI United Kingdom

December 31, 1974 - February 28, 2006



Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Return on equity is calculated by dividing the earnings per share by the book value per share. Book value per share is calculated by dividing the index price by its price/book ratio. Earnings per share is calculated by dividing the price index by its price/earnings ratio.

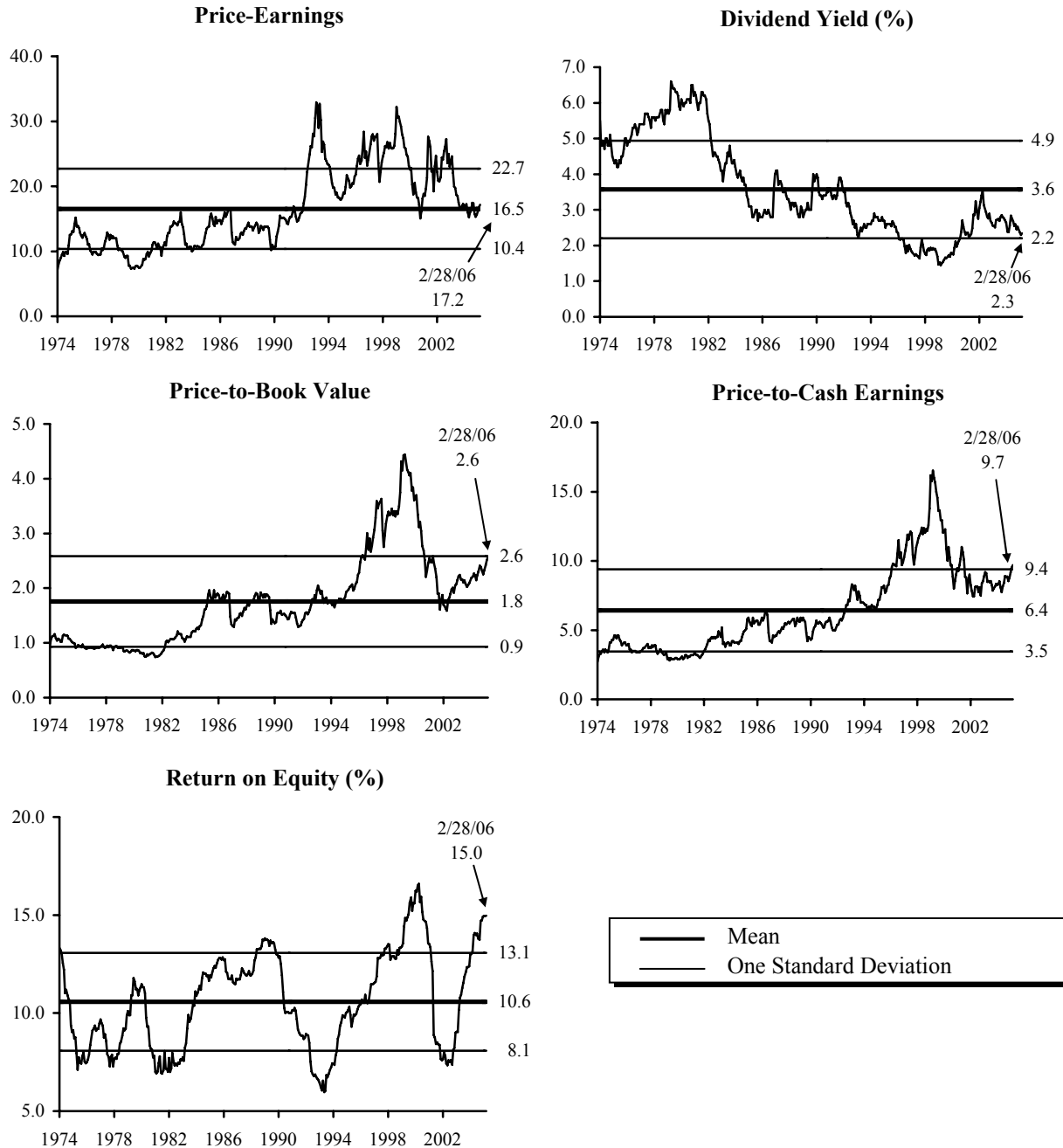
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Table B

GLOBAL EQUITY MARKET VALUATIONS

MSCI Europe ex U.K. Index

December 31, 1974 - February 28, 2006



Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

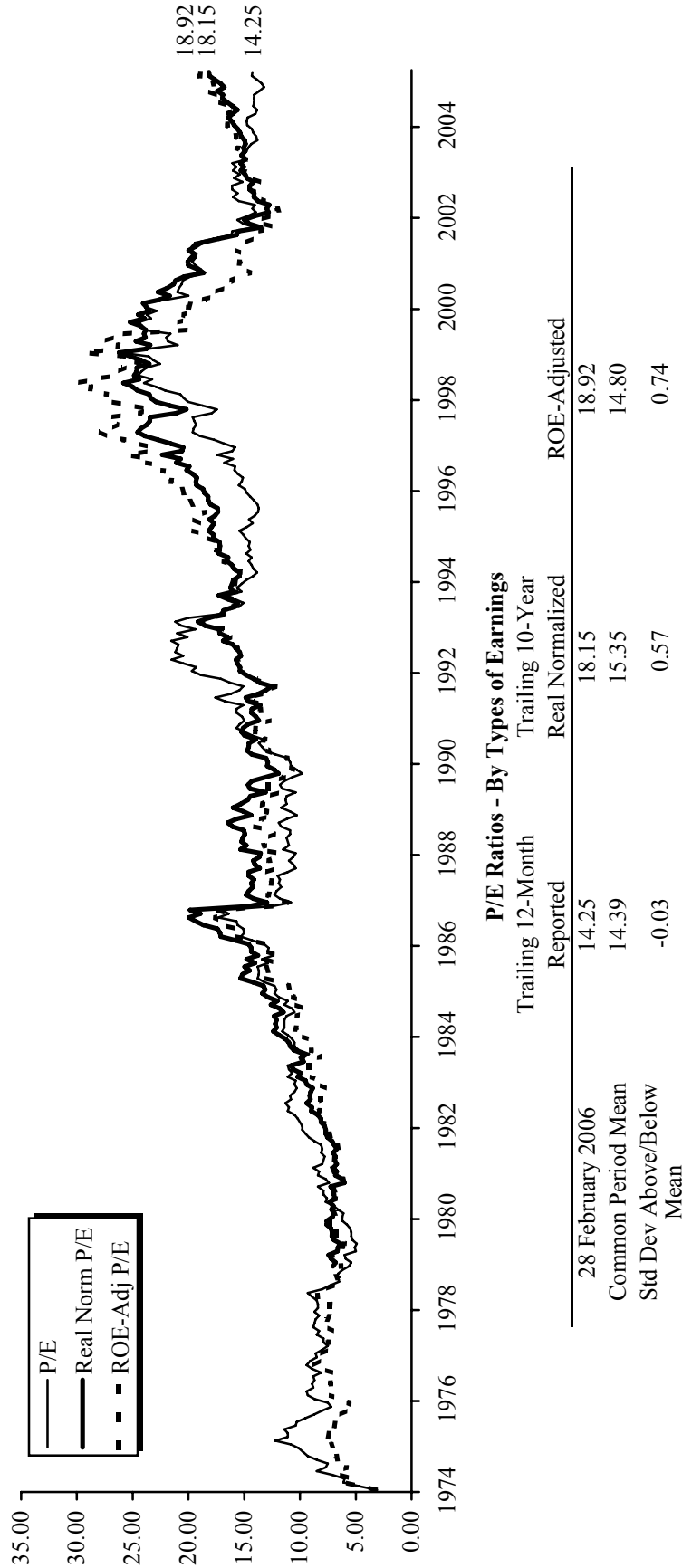
Notes: Return on equity is calculated by dividing the earnings per share by the book value per share. Book value per share is calculated by dividing the index price by its price/book ratio. Earnings per share is calculated by dividing the price index by its price/earnings ratio.

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Table C
PRICE-EARNINGS RATIOS USING VARIOUS EARNINGS DEFINITIONS

MSCI United Kingdom

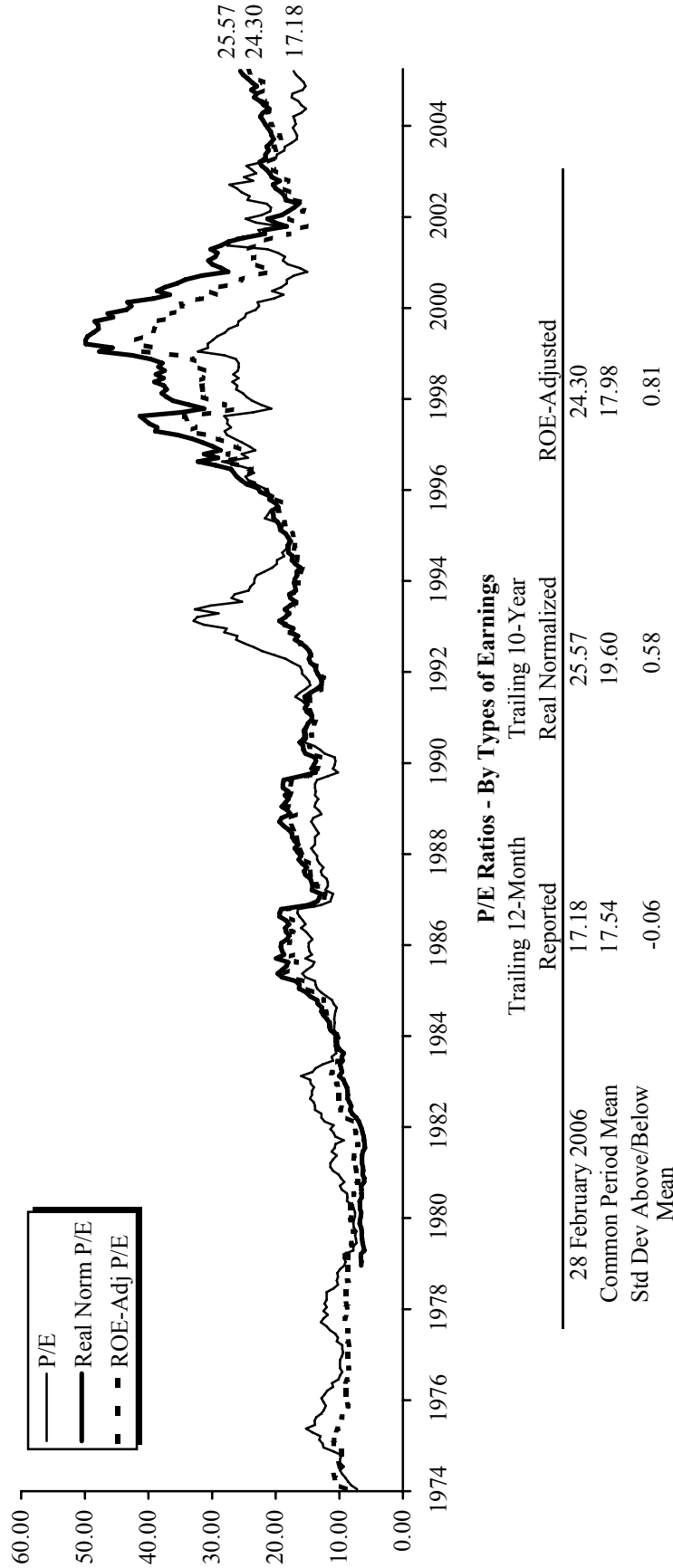
31 December 1974 - 28 February 2006



Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Normalized real price/earnings ratios are calculated by dividing the current index value by the annualized average real earnings for the trailing ten years. U.K. inflation data represent the Retail Price Index from 1974 through November 2003 and the U.K. CPI from December 2003 onward. Inflation data are through 31 January 2006. Return on equity is calculated by dividing the index's price/book ratio by its price/earnings 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.

Table D
PRICE-EARNINGS RATIOS USING VARIOUS EARNINGS DEFINITIONS
MSCI Europe ex U.K.
31 December 1974 - 28 February 2006



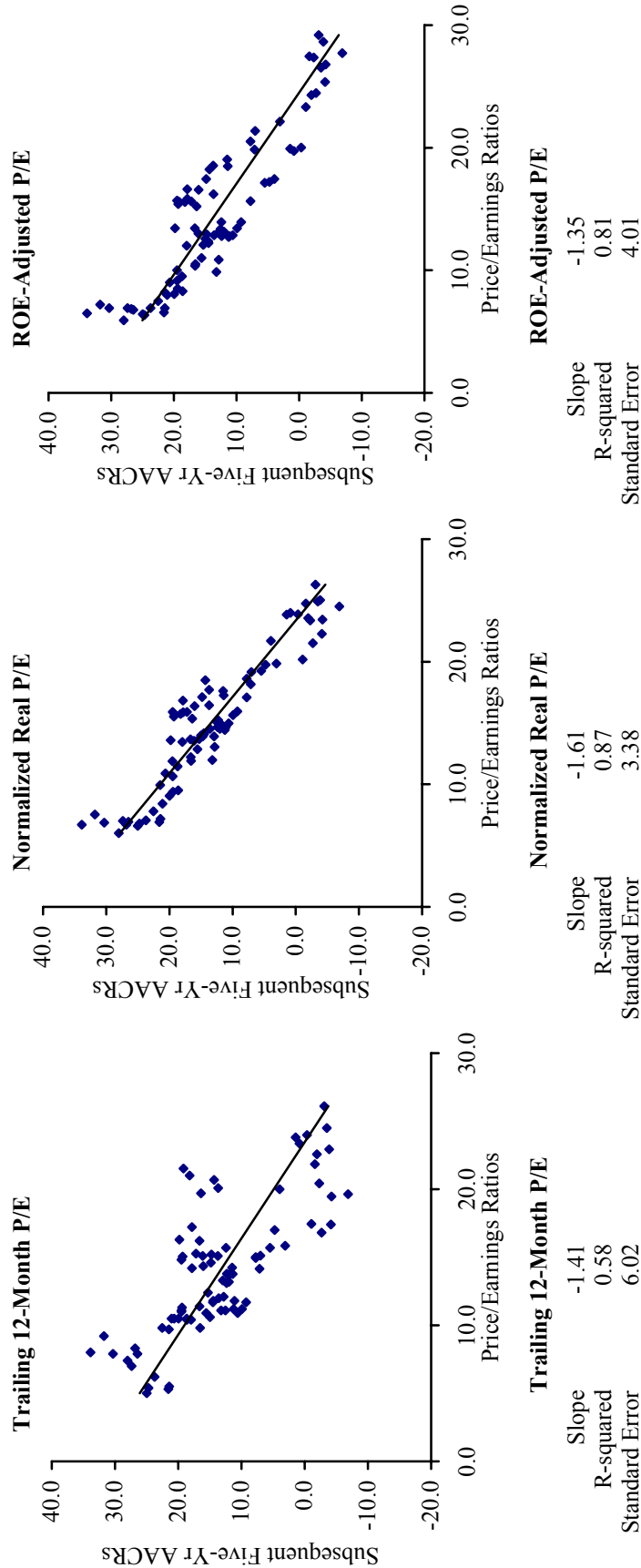
Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Normalized real price/earnings ratios are calculated by dividing the current index value by the annualized average real earnings for the trailing ten years. Inflation data are through 31 December 2005. Return on equity is calculated by dividing the index's price/book ratio by its price/earnings 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.

Table E
RELATIONSHIP BETWEEN PRICE/EARNINGS RATIOS AND FIVE-YEAR SUBSEQUENT RETURNS

MSCI United Kingdom

31 December 1979 - 28 February 2006



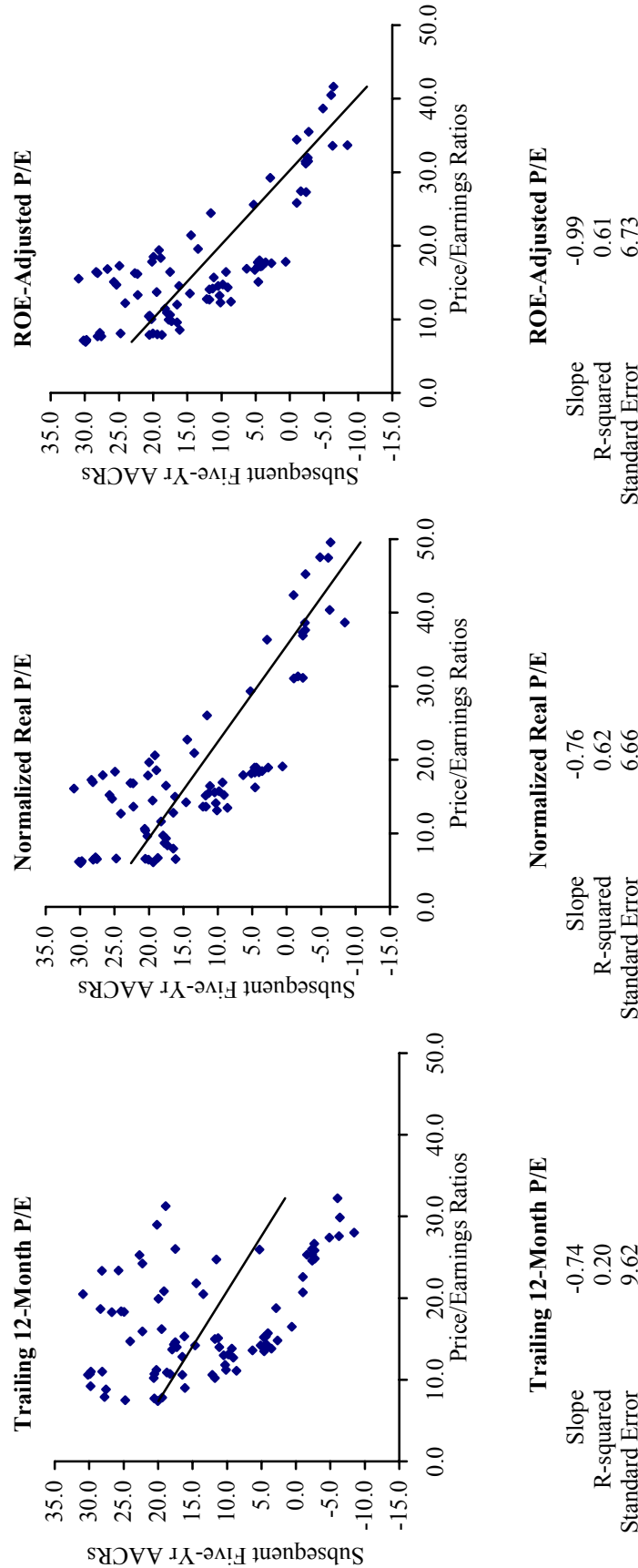
Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Normalized real price-earnings ratios are calculated by dividing the current index value by the annualized average real earnings for the trailing ten years. U.K. inflation data represent the Retail Price Index from 1974 through 2003 and the U.K. CPI from 2004 onward. Inflation data are through 31 January 2006. Return on equity is calculated by dividing the index's price/book ratio by its price/earnings 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. Graph represents quarterly data except for the most current figure.

Table F
RELATIONSHIP BETWEEN PRICE/EARNINGS RATIOS AND FIVE-YEAR SUBSEQUENT RETURNS

MSCI Europe ex U.K.

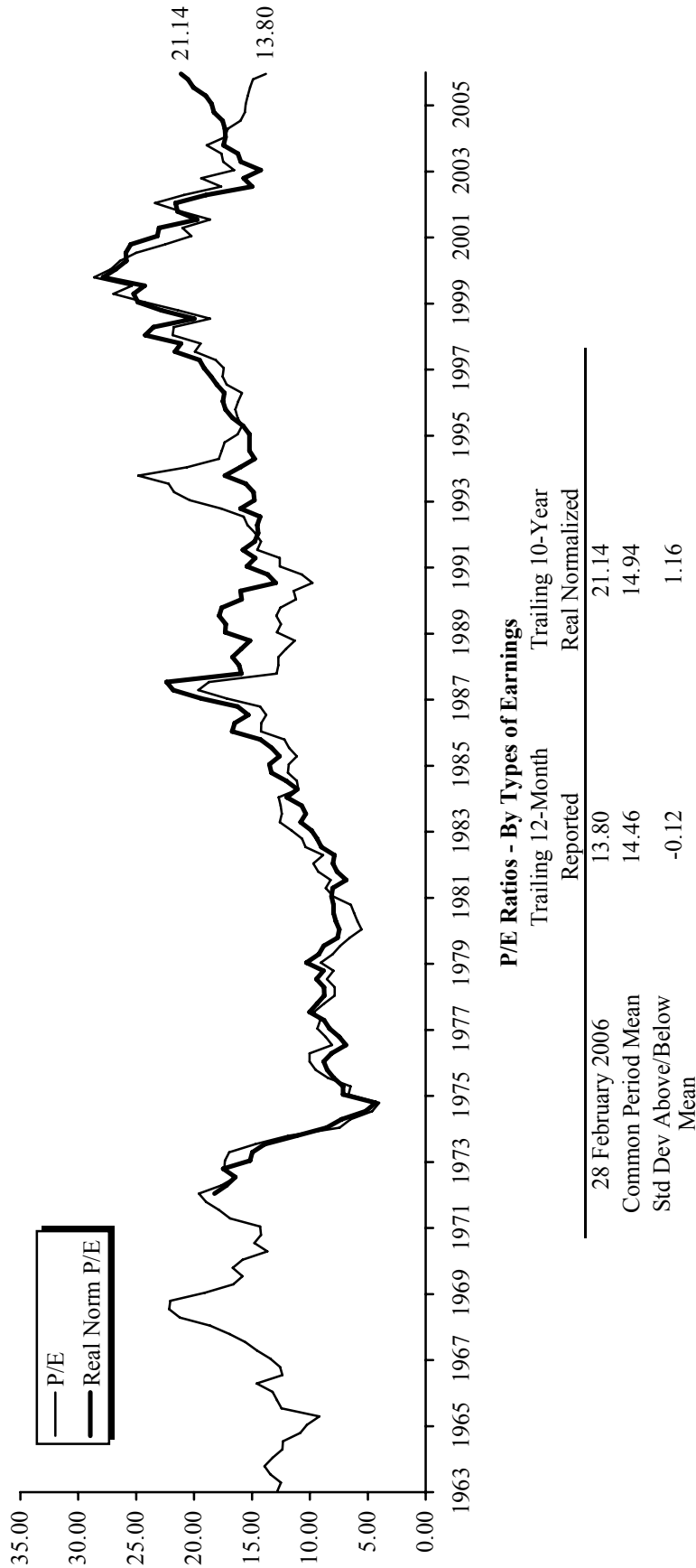
31 December 1979 - 28 February 2006



Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Normalized real price/earnings ratios are calculated by dividing the current index value by the annualized average real earnings for the trailing ten years. Inflation data are through 31 December 2005. Return on equity is calculated by dividing the index's price/book ratio by its price/earnings 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. Graphs represent quarterly data except the most current figure.

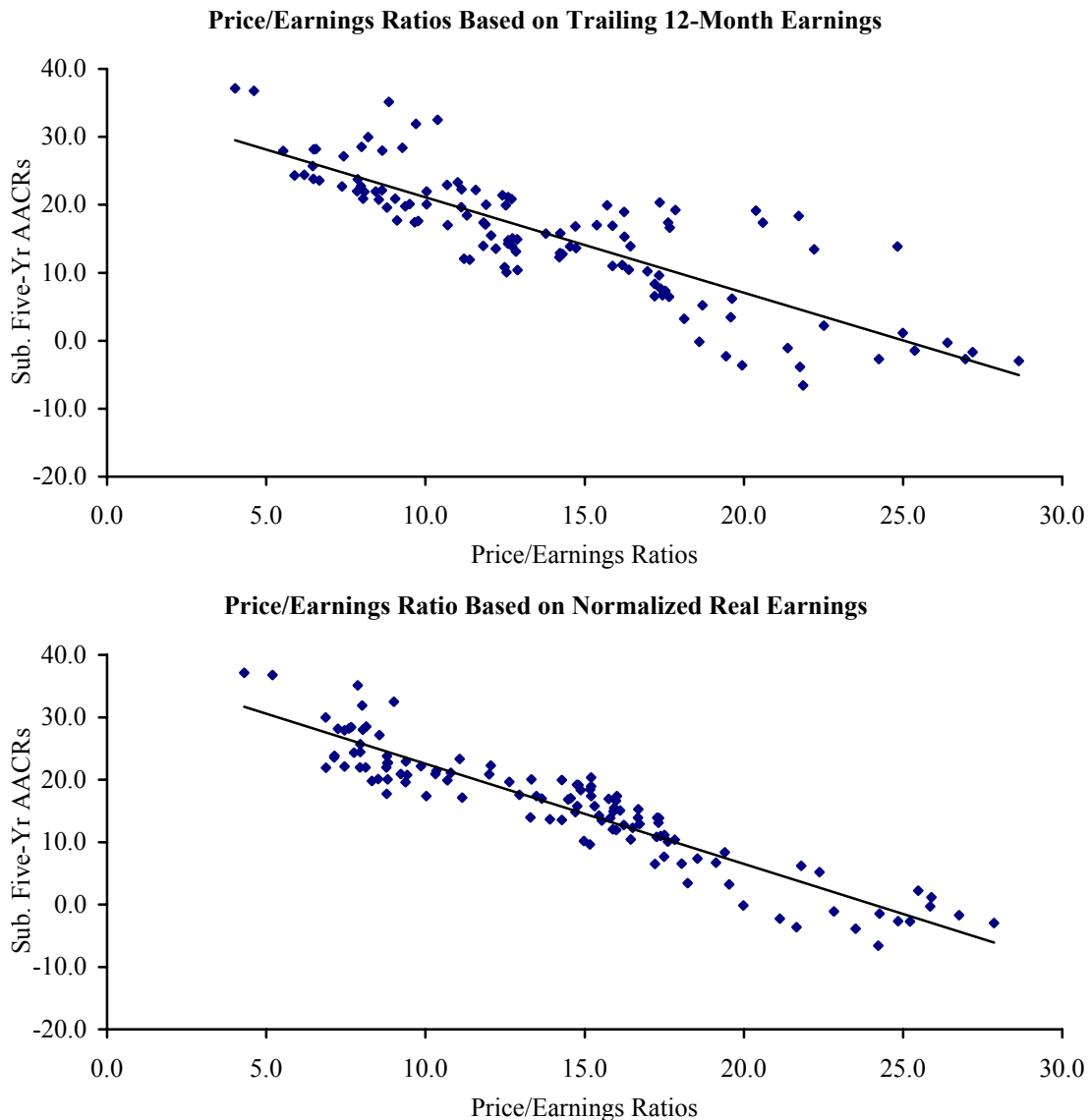
Table G
FTSE COMPOSITE PRICE/EARNINGS RATIOS SINCE 1963
31 March 1963 - 28 February 2006



Sources: FTSE International Limited and Thomson Datastream.

Notes: FTSE Composite valuations are derived from data provided by FT Actuaries Library (1963-64) and based on the FTSE Total Non-Financial Index (1964-92) and FTSE All-Share Index (1993-2005). Normalized real price/earnings ratios for the FTSE Composite Index are calculated by dividing the current index value by the annualized average real earnings for the trailing ten years. U.K. inflation data use the Retail Price Index from 1963 through 2003 and the U.K. CPI from 2004 onward. Inflation data are as of 31 January 2006. Common period represents data from first quarter 1972 onward.

Table H

RELATIONSHIP BETWEEN PRICE/EARNINGS RATIOS AND SUBSEQUENT RETURNS**FTSE Composite Index****First Quarter 1972 - Fourth Quarter 2005**

Sources: FTSE International Limited and Thomson Datastream.

Notes: FTSE Composite valuations are derived from data provided by FT Actuaries Library (1963-64) and based on the FTSE Total Non-Financial Index (1964-92) and FTSE All-Share Index (1993-2005). Normalized real price/earnings ratios for the FTSE Composite Index are calculated by dividing the current index value by the annualized average real earnings for the trailing ten years.