



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

U.K. EQUITY VALUATIONS: A CROSS-SECTIONAL PEEK

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U.K. Equity Valuations: A Cross-Sectional Peek

Since March we have held the view that despite price-to-earnings (P/E) ratios remaining near their historical averages, U.K. equities are in fact overvalued given our belief that both earnings and return on equity (ROE) appear to be approaching peak levels and that earnings growth expectations priced into the markets may prove to be unrealistic going forward.¹ In this commentary, we take a closer look at valuations across the U.K. market in search of pockets of relative undervaluation.

While the FTSE All-Share Index appears fairly valued, trading at a P/E ratio of 14.4 at the end of April, on par with its 14.6 average since 1963, valuations of market capitalization-weighted indices reveal little about the underlying valuation dispersion across shares, particularly given the concentration of the U.K. equity market.² A quick cross-sectional peek shows a less benign valuation picture. The *median* P/E ratio for companies in the FTSE All-Share is a whopping 19.3. Even more striking is the fact that the median P/E ratio of each capitalization decile of the All-Share is higher than the head-line P/E ratio, with the top decile of the market (the largest companies) sporting the lowest median P/E at 16.7. Clearly the vast majority of U.K.-listed companies trade at a much higher P/E valuation than the mild 13 or 14 multiple of the broad cap-weighted indices. (Tables A and B.)

Similarly, a comparison of the various capitalization indices in Table A reveals that large-cap shares appear undervalued relative to mid and small caps, with the large-cap FTSE 100 trading at a much lower P/E ratio (13.2) than the mid-cap FTSE 250 (21.1) and the FTSE Small (56.8). Unfortunately, the valuation history for the FTSE 100, FTSE 250, and FTSE SmallCap indices are rather limited, with official P/E ratios reaching back only to June 1993 (while dividend yields [DYs] are available from December 1985). As such, this history must be taken with a grain of salt, as this short time period is skewed by the massive large-cap overvaluation of the late 1990s tech bubble. However, at 13.2, large-cap P/E ratios are now at their lowest levels since our data begin in 1993 and more than a full standard deviation away from their historical (albeit bloated) mean. Mid and small caps, meanwhile, have seen their P/E valuations steadily climb from the market bottom in 2003, and are now above their historical averages.

Part of this multiple expansion represents a growing “bid premium” placed on smaller companies in the United Kingdom, especially mid caps, as a reflection of their potential attractiveness as merger and acquisition (M&A) take-over targets. Over the past 12 months large-cap P/E ratios have contracted 7.7%, while mid- and small-cap earnings multiples have expanded by 14.5% and 80.9%, respectively. Indeed, much of the recent surge in mid-cap stock prices reflects the rampant M&A speculation taking place in the sector. However, this story may already be discounted by the market as there are signs that the M&A cycle is maturing, with the number of U.K. acquisitions slowing sharply so far in 2006, while the average deal size has increased as deals begin to move up the capitalization spectrum.

¹ For a more in-depth discussion, please see our March 2006 and April 2006 European Market Commentaries: *European Equities Getting Pricey and Are Earnings Poised to Disappoint?*

² Overall, the ten largest companies in the FTSE All-Share account for 42.2% of the index, compared with the roughly 20% share of the top ten companies for the S&P 500, MSCI Europe ex U.K., and Japan's Topix. See our June 2005 European Market Commentary: *The All-Share Grows More Concentrated*.

While it seems that a case can be made that large caps are attractive relative to the rest of the market (historical data problems aside), are large caps truly cheap? Even within the FTSE 100 Index, the capitalization weighting appears to skew the picture, as the median P/E among large-cap companies is 16.7, well above the index multiple of 13.2 (Table C). As is the case with the FTSE All-Share, the low P/E ratio of the FTSE 100 appears to be concentrated among a limited number of shares. Dividing the index into market capitalization deciles reveals that the majority of deciles have median P/E ratios trading in the 15 to 21 range, substantially above the index level P/E. With a median P/E of 12.8, only the top decile (the largest of the large caps) is priced cheap relative to the index as a whole. Indeed, if the ten largest companies are excluded, the median P/E of the FTSE 100 jumps to 17.0. Large caps certainly look less appealing when half of the companies are priced higher than 17.0x trailing 12-month earnings, particularly when earnings are likely at or near their peak.

The “Mega-Cap” Effect?

The high level of median P/E ratios, even among large caps, raises the issue of a “mega cap” effect, in which the low valuations and high index weighting of the “mega-cap” shares distorts the aggregate valuations of U.K. stock market indices. But are the mega-cap stocks themselves undervalued? Relative to their own historical average P/E ratios and DYs (which are of varied lengths and thus varying degrees of utility), eight of the top ten holdings in the FTSE All-Share currently trade at below average P/E ratios, while five trade roughly at or above their average DY (Table D). Overall, the top ten companies trade at a median P/E of 12.8 and median DY of 3.3, lower than the aggregate All-Share valuations of 14.4 and 2.9, respectively, with all seven out of ten companies sporting lower P/Es than the index and seven of the ten offering a higher DY. While it is unwise to base valuation calls solely on historical P/E ratios and DYs, clearly these shares have relatively low valuations. Furthermore, analysis by Morgan Stanley shows that the median P/E of the 20 largest companies (14.3) relative to the median P/E of the FTSE 350, (18.1) is near a 20-year low.

From a sectoral standpoint, the mega caps themselves are heavily concentrated among oil and financial companies, with two oil majors and four large banks among the top ten companies. Together, these six companies trade in a P/E range between 10.0 and 13.2. (below the index level P/E) while the remainder of the top ten companies trade at P/E ratios around 17.0, closer to the median All-Share P/E of 19.3 (Vodafone being a notable exception). Table E shows how this sector bias plays out among the broader market, with the energy and financial sectors clearly sporting the lowest earnings multiples. Given that these two sectors alone account for 45% of the All-Share, these relatively depressed P/E valuations clearly weigh on the market as a whole.

The low valuations granted toward the oil majors and large financial companies amid record corporate profits likely reflect skepticism over future growth prospects and doubts that the current profit boom is sustainable. Analysts are certainly negative regarding future oil profits, with consensus earnings growth estimates for the MSCI U.K. Energy sector flat for 2006 and turning slightly negative in 2007, the only sector other than materials (which face similar margin pressures) for which earnings are expected to

decline in 2007. Despite prices at record highs, fears linger of a collapse in oil company profits mirroring that which occurred in the 1980s as new sources of energy supply came on-line following the oil shocks of the 1970s. Indeed, with exploration costs rising and resource nationalization mounting in Latin America and elsewhere, sentiment toward the oil majors seems muted. The consensus outlook towards financials, meanwhile, remains up-beat with solid 9.2% earnings growth for 2006 despite an environment of rising global policy rates, which historically has been a headwind for the sector.

We maintain our stance that U.K. equities are overvalued, as margins and earnings are well above their trendline levels and the lopsided index weights and low valuation multiples granted to mega-cap stocks create an illusion that the U.K. market is moderately priced from an earnings standpoint. While a case could be made that the mega-cap sector is somewhat cheap, or at least fairly valued, relative to the rest of the market, the oil and financial sectors, in which mega-cap shares are concentrated, should face increasing headwinds. Furthermore, given the paucity of low P/E ratio stocks to choose from, managers should find it difficult to build portfolios with valuations as low as the benchmark FTSE All-Share without taking on more concentration in either the mega-cap shares and/or financials and energy shares that dominate the index.

Table A
VALUATIONS OF U.K. EQUITY INDICES

30 April 2006

Name	Mkt Cap (millions £)	Price/Earnings Ratios				Date Since	+/- Std Dev from Hist Avg	Median P/E*
		All-Share Weight (%)	Current P/E	Historical Avg	Historical Avg			
FTSE All-Share	1,806,986.2	--	14.4	14.6	Mar-1963	-0.04	19.3	
FTSE 100	1,487,093.1	82.3	13.2	19.2	Jun-1993	-1.33	16.7	
FTSE 250	258,611.5	14.3	21.1	20.4	Jun-1993	0.30	20.0	
FTSE Small	61,281.7	3.4	56.8	37.6	Jun-1993	0.60	--	

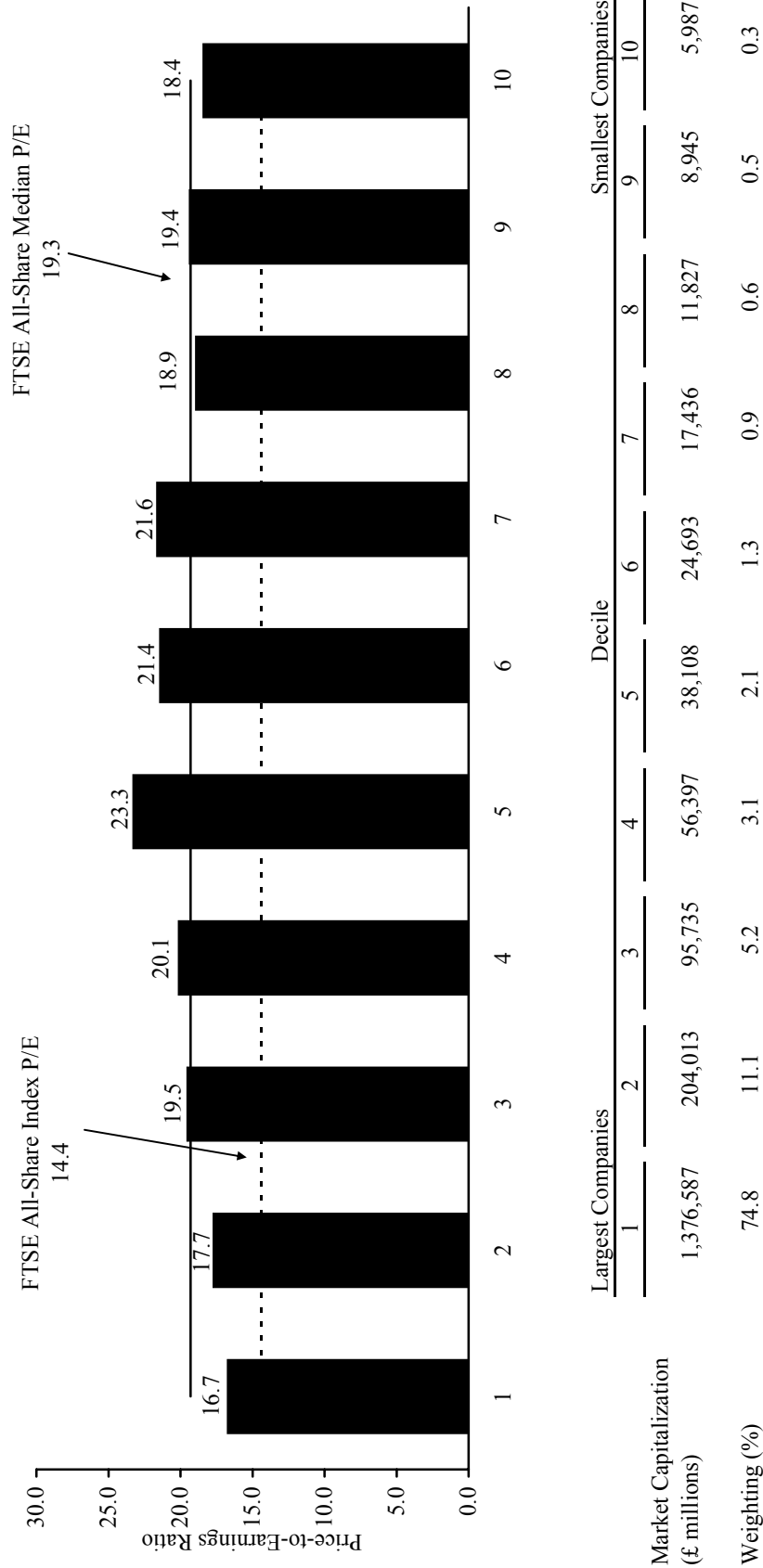
Name	Mkt Cap (millions £)	Dividend Yields (%)				Date Since	+/- Std Dev from Hist Avg	Median DY*
		All-Share Weight (%)	Current DY	Historical Avg	Historical Avg			
FTSE All-Share	1,806,986.2	--	2.9	4.4	Mar-1963	-1.06	2.2	
FTSE 100	1,487,093.1	82.3	3.1	3.7	Dec-1985	-0.64	2.6	
FTSE 250	258,611.5	14.3	2.2	3.5	Dec-1985	-1.55	2.2	
FTSE Small	61,281.7	3.4	1.8	3.3	Dec-1985	-1.59	--	

Sources: Factset Research Systems, FTSE International Limited, and Thomson Datastream.

Notes: Historical FTSE All-Share Composite Index is based on the old FT 500 Index (1963-64), the FTSE Non-Financials Index (1964-92), and the FTSE All-Share (1993-onward). Periods for which negative P/E ratios were reported have been excluded. Median P/E ratios and dividend yields for the FTSE All-Share and subindices calculated using available data from Datastream and exclude constituents for which data were not provided.

* Seventy-one companies (mostly small-caps) were excluded from the FTSE All-Share Index and 13 companies were excluded from the FTSE 250 Index.

Table B
MEDIAN PRICE TO EARNINGS RATIOS
FTSE ALL-SHARE MARKET CAPITALIZATION DECILES

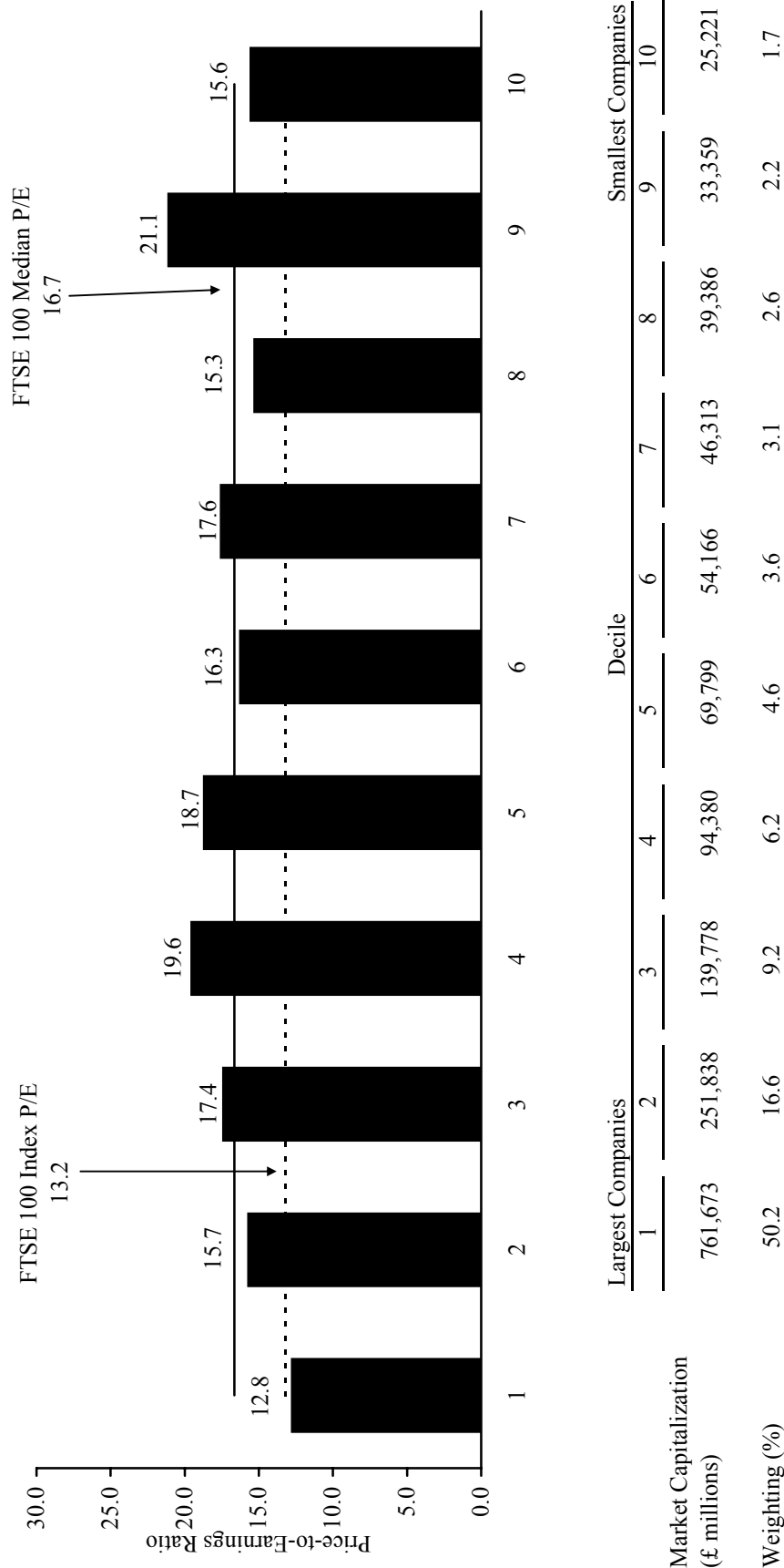


Sources: FTSE International Limited and Thomson Datastream.

Notes: Data are as of April 30, 2006. Calculations excluded approximately 71 companies for which P/E data were unavailable. Calculations also combine both A and B share classes of Royal Dutch Shell. Percentages may not total due to rounding.

Table C

**MEDIAN PRICE TO EARNINGS RATIOS
FTSE 100 MARKET CAPITALIZATION DECILES**



Sources: FTSE International Limited and Thomson Datastream.

Notes: Data are as of April 30, 2006. Calculations exclude one company for which P/E data were unavailable. Calculations also combine both A and B share classes of Royal Dutch Shell. Percentages may not total due to rounding.

Table D
VALUATIONS OF TEN LARGEST FTSE ALL-SHARE COMPANIES

30 April 2006

		Price/Earnings Ratios					
Name	Sector	Mkt Cap (millions £)	All-Share Weight (%)	Current P/E	Historical Avg	+/- Std Dev from Hist Avg	
BP	Oil & Gas	137,418.8	7.6	13.2	17.6	-0.37	
Royal Dutch Shell*	Oil & Gas	127,677.6	7.1	10.1	15.3	-0.30	
HSBC Holdings	Financials	106,746.1	5.9	12.6	15.7	-0.83	
GlaxoSmithKline	Health Care	90,657.9	5.0	17.7	20.9	-0.39	
Vodafone Group	Telecom	78,936.2	4.4	12.9	33.5	-1.06	
Royal Bank of Scotland Group	Financials	56,784.2	3.1	10.2	12.0	-0.17	
AstraZeneca	Health Care	48,013.6	2.7	17.0	24.3	-1.14	
Barclays	Financials	44,327.1	2.5	12.6	11.1	0.29	
HBOS	Financials	36,940.4	2.0	11.1	14.1	-0.66	
Anglo American	Basic Materials	34,618.9	1.9	17.5	15.4	0.37	

		Dividend Yields (%)					
Name	Sector	Mkt Cap (millions £)	All-Share Weight (%)	Current DY	Historical Avg	+/- Std Dev from Hist Avg	
BP	Oil & Gas	137,418.8	7.6	3.1	5.1	-0.96	
Royal Dutch Shell*	Oil & Gas	127,677.6	7.1	3.2	5.1	-1.21	
HSBC Holdings	Financials	106,746.1	5.9	4.4	4.0	0.44	
GlaxoSmithKline	Health Care	90,657.9	5.0	2.9	3.0	-0.12	
Vodafone Group	Telecom	78,936.2	4.4	3.4	1.5	2.53	
Royal Bank of Scotland Group	Financials	56,784.2	3.1	4.1	4.6	-0.34	
AstraZeneca	Health Care	48,013.6	2.7	2.5	2.3	0.32	
Barclays	Financials	44,327.1	2.5	3.9	4.9	-0.62	
HBOS	Financials	36,940.4	2.0	3.8	3.8	-0.11	
Anglo American	Basic Materials	34,618.9	1.9	2.2	3.5	-1.03	

Sources: Facset Research Systems, FTSE International Limited, and Thomson Datastream.

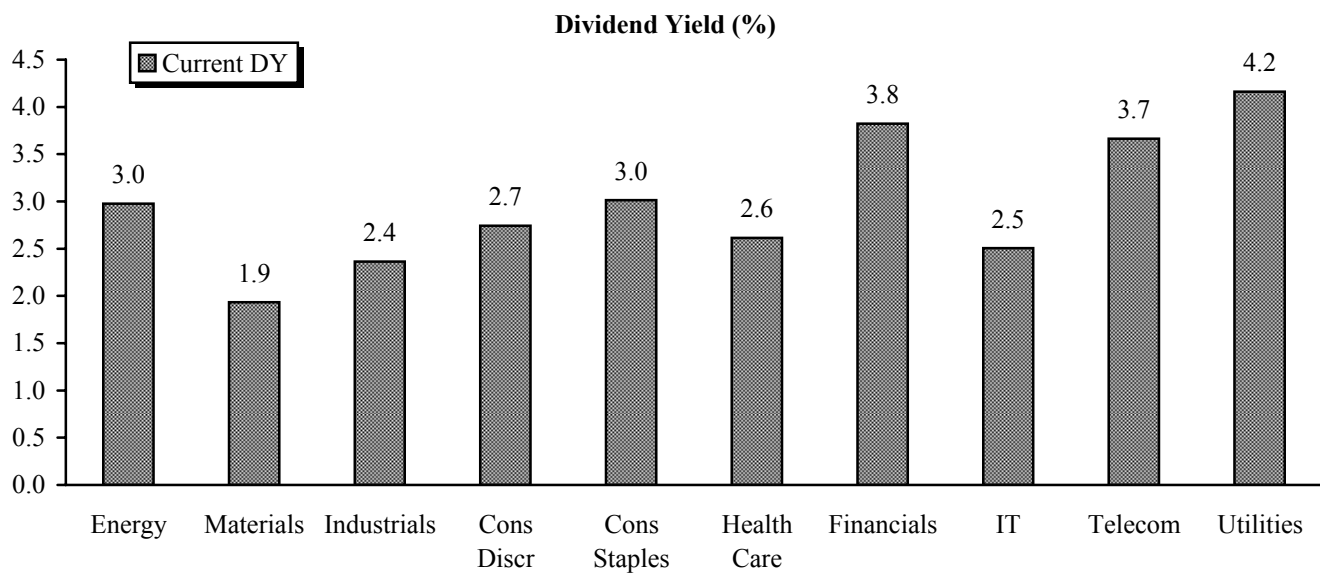
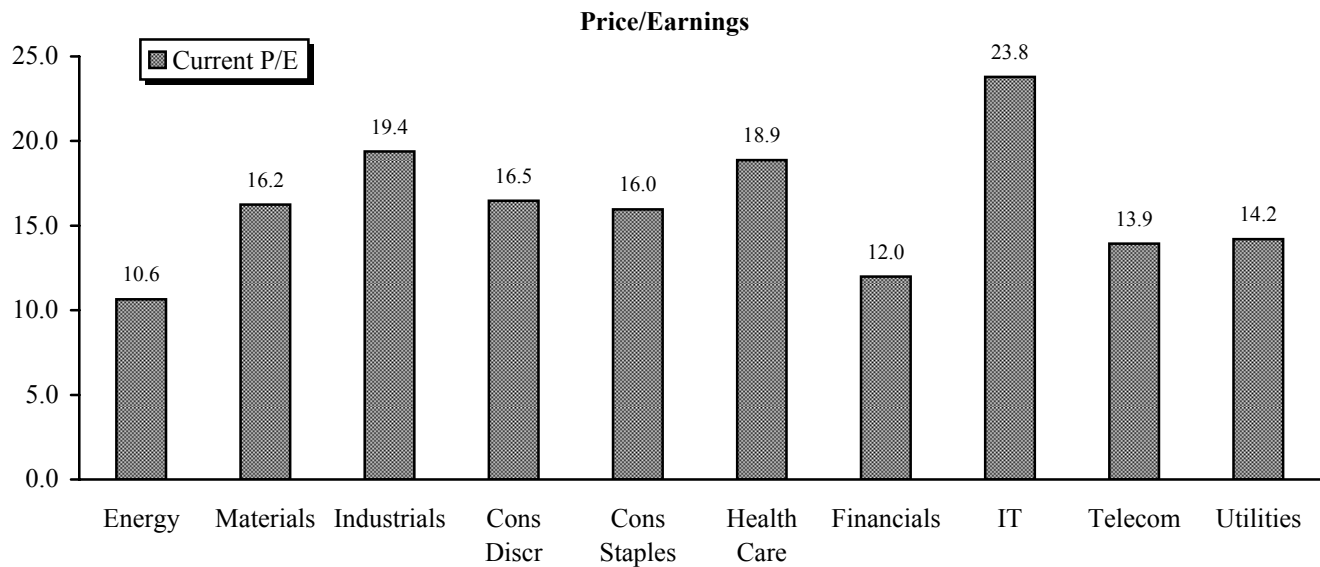
Note: As of January 1, 2006, FTSE International replaced the FTSE Global Classification System sector scheme with the Industry Classification Benchmark, or ICB, sector classification system.

* Figures combine market values for Royal Dutch Shell A shares (£73,427.1 mil) and B shares (£54,250.5 mil). Valuation data represents B share class only.

Table E

SECTOR VALUATIONS FOR THE MSCI U.K. INDEX

30 April 2006



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