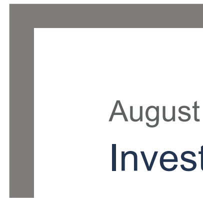

August 2013

Investment Publications Highlights

CAMBRIDGE ASSOCIATES LLC

Copyright © 2013 by Cambridge Associates LLC. All rights reserved. Confidential.

This report may not be displayed, reproduced, distributed, transmitted, or used to create derivative works in any form, in whole or in portion, by any means, without written permission from Cambridge Associates LLC ("CA"). Copying of this publication is a violation of U.S. and global copyright laws (e.g., 17 U.S.C. 101 et seq.). Violators of this copyright may be subject to liability for substantial monetary damages. The information and material published in this report are confidential and non-transferable. Therefore, recipients may not disclose any information or material derived from this report to third parties, or use information or material from this report, without prior written authorization. This report is provided for informational purposes only. It is not intended to constitute an offer of securities of any of the issuers that may be described in the report. No part of this report is intended as a recommendation of any firm or any security, unless expressly stated otherwise. Nothing contained in this report should be construed as the provision of tax or legal advice. Past performance is not indicative of future performance. Any information or opinions provided in this report are as of the date of the report and CA is under no obligation to update the information or communicate that any updates have been made. Information contained herein may have been provided by third parties, including investment firms providing information on returns and assets under management, and may not have been independently verified. CA can neither assure nor accept responsibility for accuracy, but substantial legal liability may apply to misrepresentations of results made by a manager that are delivered to CA electronically, by wire, or through the mail. Managers may report returns to CA gross (before the deduction of management fees), net (after the deduction of management fees), or both.

Cambridge Associates, LLC is a Massachusetts limited liability company with offices in Arlington, VA; Boston, MA; Dallas, TX; and Menlo Park, CA. Cambridge Associates Fiduciary Trust, LLC is a New Hampshire limited liability company chartered to serve as a non-depository trust company, and is a wholly-owned subsidiary of Cambridge Associates, LLC. Cambridge Associates Limited is registered as a limited company in England and Wales No. 06135829 and is authorised and regulated by the Financial Conduct Authority in the conduct of Investment Business. Cambridge Associates Limited, LLC is a Massachusetts limited liability company with a branch office in Sydney, Australia (ARBN 109 366 654). Cambridge Associates Asia Pte Ltd is a Singapore corporation (Registration No. 200101063G). Cambridge Associates Investment Consultancy (Beijing) Ltd is a wholly owned subsidiary of Cambridge Associates, LLC and is registered with the Beijing Administration for Industry and Commerce (Registration No. 110000450174972).

CAMBRIDGE ASSOCIATES LLC

"Europe Equity Strategy: What Is Priced In? Gains Could Come From Both Earnings Surprises and Further P/E Rerating"

Mislav Matejka, J.P. Morgan, August 12, 2013

Bullishness on European equities is becoming a consensus call among sell-side analysts. With some investors less optimistic about equities in the region, J.P. Morgan identifies two factors that will help drive Eurozone stocks higher: better-than-expected earnings per share (EPS) growth and valuation multiple expansion. An expected continuation of accommodative monetary policy should also help support equities.

Following the recent run in Eurozone equities, investors are wondering whether the rally can persist. J.P. Morgan argues that European equities should continue to outperform as a result of both better-than-consensus EPS growth and further price-earnings (P/E) multiple expansion.

One factor that will continue to support European equities is stronger GDP growth, which will boost earnings as margins expand. The massive underperformance of Eurozone equities as compared to U.S. stocks—56% since fourth quarter 2009—can be explained by earnings. While earnings in the United States have already reached new highs compared to their 2008 peak, Eurozone earnings are languishing near their 2009 lows. That is poised to change as Eurozone GDP growth finally starts to recover following a double-dip recession in 2012. Should GDP growth reach 1% or higher in the next few quarters, earnings should begin to accelerate from their lows, as the 1% growth figure is historically the rate at which profit margins and earnings in the Eurozone begin to expand. Moves in earnings also tend to be most dramatic around inflection points like the one we see today. In the past three instances when earnings growth moved from negative to positive (1994, 2003, and 2010), the rebound in EPS growth was over 30%.

A second support for Eurozone equity performance will be P/E multiple expansion. At a forward P/E of 12.2, Eurozone equities are still trading below their historical average of 13.1 despite a major re-rating from a low of 8.0 last summer. Furthermore, P/E multiples tend to be strongly correlated with Purchasing Manufacturers Index (PMI) readings. Historically, both readings above 50 and positive momentum in those readings have been consistent with subsequent multiple expansion. Eurozone PMIs have recently reached an inflection point and crossed the hurdle into expansionary territory. Finally, P/E multiples should continue to get additional support from easy monetary policy at the Bank of England and European Central Bank (ECB). If the Federal Reserve begins to "taper" its asset purchase this fall, and bond yields remain lower for longer in the Eurozone as a result, such action may also be supportive for multiples.

"Are We Nearly There Yet?"

Bank of America Merrill Lynch, August 8, 2013

Despite poor credit flow–to-GDP indicators and the ECB's looming asset quality review (AQR), European stocks have significant upside in the near term, argue Bank of America's strategists. Improving macro indicators, suppressed valuations, and positive earnings revisions could drive European equities—banks in particular—to the upper end of their trading ranges in the second half of the year.

Throughout the global economic recovery, Europe has been a passenger, relying on stronger growth in other parts of the world. Recent data on business sentiment, manufacturing activity, and earnings, however, have surprised to the upside, raising the possibility of a self-sustaining recovery. Eurozone stocks are up 12.8% year-to-date, making the common currency area the best-performing region so far in 2013.

Although several important data releases in the Eurozone have been positive, the main outlier has been disappointing lending data. Recent credit flow–to-GDP data, for example, indicate a renewed dip to -2% in second quarter after a stronger start to the year. While this latter statistic certainly marks a setback, there is a silver lining. The ECB's credit conditions survey shows credit demand sentiment at its highest since early 2012. Since sentiment tends to lead credit flow, this suggests that credit creation may improve in the second half of the year. Investors concerned with the fact that flow is still negative should remember that private sector demand rebounds not when deleveraging ends, but rather when it *slows*, as it is showing signs of doing.

One threat to a credit rebound is the ECB's AQR, which will scrutinize the balance sheets of 130 big Eurozone banks before the ECB takes over supervision. Bank of America's bank analysts think that the AQR may disincentivize banks from lending. Investors that are bearish on Europe also argue that nothing has been achieved politically to address the root causes of the crisis. Although it is indeed difficult to find much evidence of progress in improving Europe's institutions, the AQR could also help build momentum towards reform.

Despite the hurdles, on balance the backdrop for European equities looks positive. Liquidity conditions (as measured by M1) and corporate bond issuance conditions remain positive and stable. Most important, valuations are undemanding. Forward and Shiller P/E ratios, as well as price-to-book ratios, are all below their historical averages. At the same time, the 7% equity risk premium is above its own long-term average.

Equities in the much-maligned European banking sector present an attractive investment opportunity. Investors can be structurally overweight banks in the United Kingdom, Switzerland, and the Nordics, where balance sheets have largely been repaired and risks have receded. More tactical positioning may be required in Eurozone banks, for which three considerations are paramount. The first factor is timing. With generally positive economic data coming out of the Eurozone, investors will likely consider the poor credit flow–to-GDP figures to be the last indicators to bounce, putting banks in a position to outperform over the next few months. The second factor is the AQR. It seems that inevitable new capital raising requirements have not yet been priced in to the stock prices of many banks within the periphery, presenting a serious headwind to specific banks. Finally, investors should consider country-specific risks. Relatively benign credit conditions for the broad Eurozone mask sharper contraction in the periphery; Spanish banks in particular are projected to come up short of new capital raising requirements. While banks are likely to receive support from many macro factors in the near term, investors should be mindful of these serious concerns. ■