ALLIANCEBERNSTEIN

Q&A

CRACKING THE CONUNDRUM IN EUROPEAN STOCKS

There are plenty of risks in European markets today. Portfolio Manager **Andrew Birse** explains the strategies he's using to find stocks with underappreciated long-term return potential in today's complex regional conditions.

Andrew Birse is portfolio manager for European Equities at AllianceBernstein. He's also a senior research analyst. Before joining AB in 2010, Andrew spent seven years in the Corporate Finance Group at McKinsey & Company in the UK and Australia. He holds a BCom (Hons) in finance and a BA in history and economics from the University of Auckland, and an MSc in economics and philosophy from the London School of Economics.

KEY FUND FACTS:

Why AB European Equities?

+ Disciplined process focused on cash flows, implemented with a private equity-like approach
+ Differentiated research insights with global capabilities
+ Experienced investment team with extensive global research resources
+ A historically proven track record of success across different market environments*

Euro ex UK Equity: OEIC
ISIN: GB00BJMHLK84
European Equity: SICAV
ISIN: LU0128316840
Eurozone Equity: SICAV
ISIN: LU0528103707

Portfolio Management Experience

+ **Tawhid Ali**: 25 years
+ **Andrew Birse:** 16 years

* Past performance does not guarantee future results

1. It seems like political risk is dominating sentiment in European markets. How do you invest in regional stocks in this type of environment?

Andrew: It's impossible to ignore the political challenges facing European markets today. As bottom-up investors, we focus on the business dynamics that drive company results, and less on the macroeconomic or political environment. Since we don't expect to have a truly differentiated insight about how a political event might play out, it would be foolish to base an investment case on that. Market reactions to political events are also unpredictable; nobody expected US stocks to rally after President Trump's election in 2016. That said, these days, we do think about how different political outcomes might affect the earnings of individual companies, and aim to avoid excessive portfolio exposure to different political outcomes.

2. How do you consider country risk in your investment decisions?

Andrew: Our investment approach focuses on companies—not countries. That's because company fundamentals—earnings, cash flows, balance sheets and strategic advantages—ultimately drive stock returns.

Of course, country risk can affect a company's outlook. So, for example, when it comes to UK country risk related to Brexit, we're wary of companies that are vulnerable to trade disruption, currency risk and UK economic growth, such as British banks and consumer companies. Even some non-UK companies could be in danger, like Peugeot, which has significant production and sales exposure in Britain. But for other British companies with global businesses, UK country risk isn't really a problem.

Country risk can also create opportunities. During the eurozone financial crisis in 2012, concerns about France pushed down stock prices of French companies across the board. Airbus, the aircraft manufacturer, and Safran, the aircraft engine manufacturer, traded at very depressed valuations in part because they're listed in France. Yet both companies are global businesses and the fate of France was irrelevant to their fortunes.

Investors should also consider the risk of keeping equity portfolios exclusively in their home markets. Political and economic troubles in Italy, France, the UK or elsewhere could inflict disproportionate damage on an allocation that's limited to a specific country. A diversified portfolio across Europe can help reduce country risk inherent in a single-country portfolio.

3. European earnings growth and margins have historically lagged the US. What needs to happen to change this dynamic?

Andrew: European stocks have typically been cheaper than US peers, in part because European profitability has historically been lower than the US. But things may be changing. We think European companies have more scope to increase their profit margins, while US companies will probably fall from record highs over the longer term.

In 2018, US earnings advanced rapidly, driven by tax reform. This year, the trend is likely to reverse: Europe ex UK earnings per share are set to grow by 9% versus 8% for the US, according to consensus forecasts.

There are several trends in Europe that could support stronger margins. Activist investors and private equity buyers are playing a much bigger role in pressing European companies to make meaningful operational improvements. European corporate culture is also changing, with more companies simplifying their structures to improve performance. For example, companies like Philips and Siemens have been breaking themselves apart in order to focus their operations and drive operational performance. Others that do not, like GKN and Amer

Sports, are being taken over by private capital to achieve the same focus in order to drive returns.

4. What attributes do you look for when searching for companies in Europe today?

Andrew: In our investment approach, we apply a business owner mindset to stock selection. It's very similar to the way private equity funds invest. That means we search for cheap, undervalued businesses that we aim to own for five years and then sell back to the market.

In our research, we want to find companies that aren't being given credit by the market for their future cash-flow potential. As in the examples I mentioned before, the company might be in the wrong geographic location or in an industry that's out of favour. Our investment team is particularly suited to finding these companies, because most of us come from industry or consulting backgrounds. So we really understand the business dynamics in ways that typical equity investors don't.

We look for attributes that determine business and investment success. Examples include companies that are taking self-help measures to boost margins, for example, by cutting costs or expanding product ranges. Companies with sustainable competitive advantages are very appealing in a complex macro environment. And companies in industries with improving dynamics are natural portfolio candidates.

5. How is your investing approach different than some of your competitors?

Andrew: Many equity portfolio managers use fundamental research. What's different about the way we do it is the application of the private equity-like mindset, using an internal rate of return (IRR) analysis, as well as our approach to risk management.

You don't really see IRR used in funds that invest in public markets. But IRR offers some clear advantages over research based purely on earnings, which can be easily manipulated by companies and don't always show a real picture of what's going on in the business.

The IRR is the implied discount rate that the market is putting on future cash flows. Our IRR analysis looks five years ahead, calculates the dividends and cash flows that we get throughout the ownership period, and forecasts the price at which we can sell it back to the markets. In our analysis, we apply a conservative estimate of the stock's multiple. That's important because it means we are looking for investments that can generate returns without the help of a re-rating of the stock through market gains.

On the risk side, we augment standard risk models with two unique approaches. First, when researching a stock, we talk to hedge funds which are short to hear their views. Hedge funds with short positions believe these stocks will fall in the future, and we want to know why. Getting an outside view helps us avoid any in-house bias toward a company or industry and ensures that we fully understand the risks.

Second, we apply cluster risk analysis to our portfolio exposures. Groups of stocks that may not be formally classified in the same risk category often exhibit similar behaviour patterns. This could create a cluster of risk that goes undetected by standard risk models and may hurt performance during times of stress. Applying these two risk control techniques to our portfolios has helped us deliver a distinctive and smoother pattern of returns in both growth and value market environments.

Andrew's Top Three Stock Picks

AerCap—the Ireland-based aircraft leasing company has a fleet of over 1,400 aircraft and more than 200 customers in 80 countries. AerCap is benefiting from a strong global market for narrow-body aircraft and its management team has a strong track record of returning cash to shareholders, helped by its history of selling aircraft above book value to buy existing aircraft below book value.

Airbus—continues to benefit from the propensity of emerging consumers to fly, hence the demand for new aircraft has continued to show resilience. The France-listed aircraft manufacturer is also at a stage of its product portfolio where two new aircraft programmes, the A320neo and the A350, are entering an extremely profitable phase of their lifecycle, following years of development investment

Hugo Boss—the German premium suits and clothing brand is part way through a multi-year operational improvement programme that we believe is set to yield strong cash flows as the company rectifies mistakes of the past and re-focuses its offering on its historical core customer base. Hugo Boss is also making in-store operational improvements, including right sizing its retail estate.