CAZENOVE
CAPITAL MANAGEMENT

# Cazenove European Equity Ex-UK Fund

## Fund commentary – January 2012

### Market Review

2011 was a great year for large cap secure and defensive growth. Commentary has 2011 down as being an awful year to be an active manager. Volatility surged, the euro crisis drowned out stock influences, and "risk-on/risk-off" came and went with little logical narrative to justify the swings. Oh, and hardly anybody traded. Yet fund managers had on offer a relatively simple trade – long defensive and secure growth and underweight cyclical risk, as the data below for the Eurostoxx 600 highlights;

| **Sector** | **Perf in Euros** | **Sector** | **Perf in Euros** |
|---|---|---|---|
| Healthcare | +12% | Banks | -32% |
| Food & Beverage | +5% | Basic Resources | -30% |
| Oil & Gas | +1% | Autos | -24% |

When looking back at our own performance over the year, the positives we can take in what was a pretty grim year for European equities include two well-timed moves into risk assets, with a trade into banks in January and equities in general in October. We also held on to our long-held positive view on pharmaceuticals, which came right in 2011, while we avoided having too much emerging market exposure as valuations fell in response to rising inflationary pressures. Our failings were in holding on to risk a little too long after the rally had faded and not holding sufficient growth stocks, which once again had a good year in relative terms. Both mistakes were a function of maintaining a value-bias over 2011.

We enter 2012 with a conundrum – few investors carry conviction in their view yet carry extremely skewed portfolios. Commentators expect the negative trends that emerged in 2011 (Euro debt crisis, Chinese hard landing) to get worse in 2012, while US growth is expected to remain the one bright spot. Maybe 2012 will be a year of consensus being met, but there have been precious few such years in my career. As I have argued since the late summer crash, valuations in parts of the market are now very low and discount a very bad outcome. Sectors such as autos reflect this dynamic. Other sectors now trade at all-time high premiums to the market, such as Food & Beverage. Our view is not to take a view on the precise trajectory of the euro crisis nor the nuances of Chinese growth - where the fallacy of forecasting is probably highest. Our portfolio approach this year is to recognise that the dispersion of valuations in European equity markets is high – no doubt reflected in fairly skewed fund manager positioning towards all forms of perceived safety. So with dispersion so high we would argue for a more balanced portfolio than the one that worked in 2012 – namely a very defensive one. Some defensive sectors still offer a good combination of growth and valuation – pharmaceuticals still being one. Some risk sectors still offer a very poor outlook for 2012, such as cement and parts of consumer discretionary. But a portfolio with a reasonable exposure to risk through low valuations, over-pessimistic forecasts, and decent balance sheets seems appropriate. But we must be mindful of earnings risk. If 2011 was a year when PER's fell, then 2012 has the potential to be the year earnings fell.

Looking even further out than 2012 I am persuaded that equity valuations have likely moved to a new, lower range than that which has existed for much of the last twenty years. If one is of this view, then expecting outsized returns from PER expansion appears fanciful. Perhaps the rally in October is a taste of things to come – the only time outsized returns are available from equities is when volatility is extremely high and valuations very depressed – namely the time to buy equities in a bear market is when everyone is bearish. As time rolls forward, it would make some sense for returns to be driven by factors more tangible than a generalised rise in the Price-Earnings Ratio – perhaps earnings, book values, and dividends will dominate returns rather than an exogenous rise in the PER. For such an approach to reap rewards, however, investors may need to be patient, rather than live off the fuel of short term trading. Some investors may be aware that we are contemplating launching a strategy more focused on dividend returns and sustainability, and we will report on this in due course. It will not be a panacea for low equity returns. Indeed there are many threats to dividend sustainability – not least from impoverished governments. But when PER's don't structurally rise, direct returns, in the form of dividends, usually dominate total returns, especially if the starting yield is attractive. If we are to live in a world with less growth, companies whose valuations reflect little growth should be among the best performers - as they are already prepared for the low growth world than is the stock with the fancy rating. I have read somewhere that this is No Market for Young Men. Perhaps it may be better described as No Market for the Impatient.

## Fund Review

The fund modestly underperformed in December, with the main contributor being our position in Metro, the German retailer, which issued a pre-Christmas warning on trading conditions, perhaps a sign of the earnings risk to come. We have reduced our exposure as the weakness in trading, which was across all business lines, may hint at something more than just cyclical. On the positive side the two best stocks were Sanofi and Novartis, both adding 20bps each to performance. It is interesting to note that 3 years after the peak of the financial crisis, the major pharmaceutical stocks have recaptured their relative highs they established in October 2008. For all the money pumping since the crisis began, pharmaceutical stocks have been outstanding performers over the last four years.

## Fund Strategy

As outlined above we move into the New Year with a balanced portfolio – in the sense that we do not expect secure and defensive growth to have such a stellar year as it did in 2011. Our main underweights are financials (-3.6%) and growth (-5.9%), while our main business cycle overweight is Consumer Cyclicals (+7.5%), with most other Business Cycle Styles close to neutral. December ended the year on a more positive tone, and January has started well too. I noted last month that the latest Eurozone meeting was a recipe for long term break-up of the union if it were followed to its logical end. I doubt Merkel's plan will ever get off the ground, and in the meantime the ECB is offering unlimited 3 year funds to banks. This will ease the immediate liquidity crisis, but will almost certainly turn the Eurozone banking sector into a Japanese zombie system.

Chris Rice, January 2012

## Regulatory Information and Risk Warnings

This document is issued by Cazenove Capital which is the name under which Cazenove Capital Management Limited (registered No. 3017060) and Cazenove Investment Fund Management Limited (registered No. 2134680) both authorised and regulated by the Financial Services Authority provide investment products and services.

Unless otherwise stated all data is sourced from Cazenove Capital and DataStream. This document may include forward-looking statements that are based upon our current opinions, expectations and projections. We undertake no obligation to update or revise any forward looking statements. Actual results could differ materially from those anticipated in the forward-looking statements. Past performance is not a guide to future performance. The value of investments and the income from them can go down as well as up and an investor may not get back the amount originally invested and may be affected by fluctuations in exchange rates. The levels and bases of tax assumptions may change. You should obtain advice on taxation where appropriate before proceeding with any investment.

This document is for information purposes only and does not constitute an offer to enter into any contract/agreement nor is it a solicitation to buy or sell any investment or to provide any services referred to therein. Telephone calls may be recorded for training and monitoring purposes.

Cazenove Capital Management Limited provides independent advice.

Cazenove Capital Management Limited, 12 Moorgate, London EC2R 6DA. Telephone +44 (0)20 3479 1000.
www.cazenovecapital.com/investmentfunds

Registered Office 12 Moorgate London EC2R 6DA.

## For Swiss domiciled clients the following applies:

Der Verkaufsprospekt, dervereinfachte Verkaufsprospekt, die Satzung kt sowie der Jahres- und Halbjahresbericht können in der Schweiz kostenlos bei unserem Vertreter, der First Independent Fund Services, Klausstrasse 33, CH-8008 Zürich, bezogen werden.

Die Zahlstelle ist die Neue Privat Bank AG, Limmatquai 122, CH- 8022 Zürich.

The prospectus, the simplified prospectus, copies of the articles of association and the annual and semi-annual reports may be obtained free of charge from our Swiss representative First Independent Fund Services, Klausstrasse 33, CH-8008 Zürich.

Swiss paying agent: Neue Privat Bank AG, Limmatquai 122, CH- 8022 Zürich

Cazenove Capital Management Limited, 12 Moorgate, London EC2R 6DA. Telephone +44 (0)20 3479 1000.
www.cazenovecapital.com/investmentfunds

Registered Office 12 Moorgate London EC2R 6DA.