

# MARKET OUTLOOK

NICK SHERIDAN ON EUROPEAN EQUITIES – SEPT 2008



Nick Sheridan, manager of the New Star European Value Fund, comments below on the recent stockmarket volatility, his outlook for Europe and his conviction that we are entering classic value-investing territory.

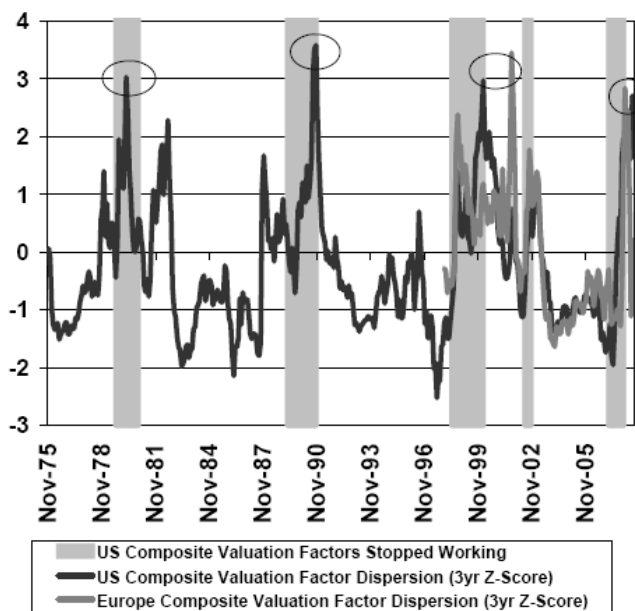


European value investors faced severe headwinds during the first eight months of 2008, with equities continuing to fall. Investors remained concerned over the potential of a eurozone recession and valuations, despite appearing attractive, fell further. This market weakness, however, provided increasingly fertile ground for value investing as opportunities emerged to buy high-quality stocks at reduced prices.

Since the summer of 2007, growth investing has had the upper hand, with investors being rewarded in relative terms for buying growth companies. By contrast, value investing was out of favour. A turning point, however, now appears to have been reached.

Value tends to reassert itself when valuation dispersions reach such extremes as faced by European investors recently, as shown in the graph below. Analysts have found that early in a bear market, when the valuation dispersion between cheap and expensive stocks is more than two standard deviations wider than is normally the case, cheap stocks will shortly begin to outperform. Backtesting by Morgan Stanley suggests that cheap stocks tend to outperform expensive stocks in the subsequent 12 months following at least a two standard deviation signal.

Valuation dispersions in Europe and US (measured in standard deviation):



Source: Morgan Stanley Quantitative & Derivative Strategies, Morgan Stanley Research. Positive = value cheap relative to growth; negative = value expensive relative to growth. Z scores = composite valuation dispersion away from a three-year rolling average.

Historically, the start of an earnings recession often indicates the return in importance of valuation factors for investors. The market tends to discount the upcoming recession by 12 months and during that period investors have little confidence in earnings due to concerns regarding

forecast risks. In this environment, valuation factors do not shape market moves. After the ensuing market correction, a point is reached where most of the risk is priced in, incremental forecast risks are much reduced, investors have more confidence in earnings and valuation again returns to the fore.

Valuation criteria, such as price-to-book ratios and dividend yields, reached compelling levels at the end of August. A prime example of the good value that surfaced in the wake of market weakness is the fund's recent acquisition of Sanofi-Aventis. This is the first time in three years that the fund's proprietary quantitative analysis screens have highlighted a pharmaceutical company as having sound fundamental characteristics available at a fair valuation. Pharmaceutical stocks have historically been too highly priced to be considered but Sanofi-Aventis was bought in response to its compelling dividend yield, low price-to-book ratio and low price-earnings (PE) ratio.

Whilst the fund is quick to buy attractive stocks, it is equally prepared to sell underperforming stocks. Swiss Life was bought when it was trading on a high dividend yield, a low PE ratio and a low price-to-book ratio. In addition it was showing strong returns on equity (ROE) and had announced plans to buy back 20% of its equity. The holding, however, was recently sold when these value criteria were erased after its directors made a value destroying acquisition and cancelled the share buyback plans.

Compelling valuation opportunities have to be weighed against European economic prospects, which are looking weak. The Organisation for Economic Cooperation and Development (OECD) has lowered its growth forecasts for the eurozone. The OECD said the zone's 15 countries would avoid technical recession – two quarters of contraction – but would grow by just 1.3% overall, down from previous expectations of 1.7% growth. Whilst the falls in the oil price have reduced inflationary pressures, the housing market downturn is spreading out from countries such as Ireland, Spain and the UK, which have already suffered sharp corrections.

With the eurozone facing subdued economic growth and at worst full-scale recession and market conditions likely to remain challenging, the fund is positioned to weather the storm through its bottom-up approach with stock analysis at the core.

Value investing is a tried and tested investment philosophy. Whilst it does not boast the sharp bursts of outperformance that growth investing can deliver, the discount-from-value approach has, in the past, outperformed over the long run. Historically, those US fund managers that stuck to the value principles of Graham and Dodd's Security Analysis have suffered periods of underperformance but significantly outperformed over their careers. With this precedent in mind, the fund's focus is on cherry picking stocks whose prices have been beaten down in the current market but whose long-term prospects remain robust.



Past performance is not necessarily a guide to future performance. The opinions expressed here represent the views of the fund manager at the time of writing and should not be interpreted as investment advice.



## NEW STAR EUROPEAN VALUE FUND

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Past performance is not necessarily a guide to future performance. The value of investments and any income from them may fall as well as rise and investors may not get back the amount originally invested. The value of investments may also increase or decrease as a result of changes in exchange rates between currencies. The opinions expressed here are solely those of the fund manager at the time of print and should not be interpreted as investment advice.

The New Star European Value Fund (formerly the Tilney European Growth Fund) (the "Fund") opened to retail investment on 29 June 2007. Performance history for the Fund includes that of the Tilney European Growth Fund which was launched on 1 October 1997.

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Full details of the Fund can be found in the prospectus. Any decisions should be made solely on the basis of the relevant documents, which are available on request from New Star. The Simplified Prospectus is also available upon request.

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### FUND FEATURES

- Active portfolio management
- Distinctive value investment process
- Stock specific, with no deliberate sector or country bias

### FUND AT A GLANCE

Launch date:	01.10.1997*
Base currency:	Sterling
Other currency classes:	€ share class: launch date 03.09.2007
ISIN EUR:	GB00B1XQM616
Bloomberg:	NEWSEVE LN
Sedol:	B1XQM61
Registration:	UK, Italy, Spain, France and Singapore (recognised).

Fund information at 29 August 2008.

\*Originally authorised as the Tilney European Growth Fund on 1 October 1997

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