

Rich pickings in European energy small caps, says Longden



Continental European smaller company share prices traditionally begin a new calendar year with a flourish, as optimistic investors put money to work across a range of asset classes. But 2008 could not have been any more different with the benchmark HSBC Smaller Europe (ex UK) Index falling by 13.0% in January alone in Euro total return terms and by an even larger 18.2% in the first six months of the year (Source: Datastream). "This time round there was no anticipation of upbeat trading statements from company managers", said Crispin Longden, manager of the F&C European SmallCap Fund. "Rather it was a case of worrying about the likely impact of the persistent credit crisis on the real economy". The economic news out of Europe proved to be better than feared, at least in respect of the first three months of the year, while the annual results season passed off with relatively few negative surprises. However one concern which lingered on in investors' minds was the rapid increase in energy and food prices which threatened to push up underlying inflation and sabotage growth. Given this backdrop, it is scarcely surprising that one of the few industry sectors capable of bucking the downwards trend in markets was energy. The major quoted oil and gas concerns tend to grab the headlines in this respect but the smaller company universe also has rich pickings. "Our continental European smaller cap portfolios have recently benefited from holdings in names such as Schoeller Bleckmann", Longden stated. The Austrian company is the global market leader in non-magnetic high-precision components used in oil drilling equipment. In the six months ending June 2008, Schoeller Bleckmann appreciated 13.4% in Euro total return terms. With the current uncertain mood in the stock

markets, it pays to be very wary about companies with a limited trading history, so Longden. "A franchise which appears robust could evaporate at the first sign of falling demand; an apparent solid earnings base built on operating leverage could disintegrate as soon as sales growth starts to falter. It is much easier to arrive at a valuation for stocks whose longevity through economic ups and downs allows forecasts for shareholder returns to be modelled accurately rather than simply guessed at". A prime example in Longden's portfolios is Swiss Logitech. The computer accessories company has just reported record quarterly earnings. It is on course to deliver double-digit percentage growth in sales and operating profits for the last eight years in a row. "A record which justifies a premium share price valuation", he said.

INDIAN OPPORTUNITIES

F&C has moved overweight in India within its global emerging markets funds, as earnings continue to be strong and valuations are at attractive levels. According to Jeff Chowdhry, Head of Emerging Equities at F&C, India is now one of his team's favourite bets for the next 12 months. "Despite the disappointing performance of the Indian market in recent months, we have remained very positive on the secular outlook for India. Six months ago we were concerned about valuations but these have come down a lot and the market has corrected by 35% since the beginning of the year," he said. "Whereas India was one of the most expensive emerging markets a few months ago, today it's one of the cheapest as well as being one of the most attractive on fundamentals." Chowdhry points out that the sell-side analysts at brokers and investment banks are almost universally bearish on their outlook for India primarily because of rising inflation and interest rates worries. "This negativity is being reflected in stock prices and creates opportunities for us. Our view is that oil prices are unlikely to continue rising. We expect Indian inflation and interest rates come down over the next 12 months." The Indian market has also been under

pressure by huge outflows of foreign money since the start of the year. "Our estimates tell us that \$6bn of foreign money left the Indian market this year but we expect those outflows to slowdown, relieving that pressure," he added. F&C's is currently overweighting India by 3% above the benchmark. In order to buy more Indian stocks, Chowdhry's team has sold positions in Malaysia and Korea, countries that are unlikely to outperform under the current global economic environment. The team has also slightly reduced its overweight position in Brazil, its favoured Latin American market. Favoured Indian stocks include Reliance Industries, a dominant player in the oil and gas market, and HDFC, the country's largest mortgage lender which provides loans to the rising middle classes. Chowdhry concluded: "On valuation, the Indian market now sells on a forward price earnings multiple of 12 which is below its 5-year average and below the Global Emerging Market average," Chowdhry explained. "We expect earnings growth of 20% over the next 12 months and therefore, even if the market does not re-rate, the Indian stock market can rise at least 20% from current levels."

GOING FOR GOLD

As the Beijing Olympics loom closer, China is attracting unprecedented public attention. Recent photos of the sites shrouded in heavy fog act as a reminder of the effects of pollution and climate change. In its latest quarterly **reo**®-report on environmental, social, and governance (ESG) engagement, F&C highlights the environmental challenges that threaten Chinese companies' business. The note on China identifies key issues that may impact companies over the next 10 years. It concludes that companies are only waking up to the impact that issues such as air and water pollution will have on both China's economy and their own business performance. "For sustainable, long-term economic growth, companies need urgently to address emerging risks, such as climate change, human rights and corruption, and seize opportunities to offer winning solutions", said Karina Litvack, Head of Governance & Sustainable Investments at F&C.

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