# A BOTTOM-UP SEARCH FOR GROWTH STOCKS IN THE EUROPEAN MARKETPLACE

**FUND FACTS**

**INVESCO EUROPEAN FUND**

**CATEGORY:**
International

**PERFORMANCE:** (thru 6/30/98)

| | Fund | Category |
|---|---|---|
| *1 Year* | 44.2 | –2.9 |
| *3 Years* | 30.2 | 9.7 |
| *5 Years* | 22.9 | 9.4 |

**RISK:** (relative to category)
Average

**TOTAL ASSETS:** (as of 3/31/98)
$512 million

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*With the U.S. markets still sizzling, the returns of many international funds seem lukewarm in comparison. But international returns in general have been dragged down by poor regional performances—notably Japan and the once-hot Asian Tigers. And that has tended to mask exceptionally high returns in Europe.*

*One European fund that has done well relative to its peers is the INVESCO European Fund, managed by INVESCO Asset Management Ltd., the London-based parent company of the INVESCO fund family. The fund was among the top 25% of all international funds for the last year, three years and five years through June 30, and it has been one of the top performers among European specialty funds. (For an overview of European mutual funds, see this month's Mutual Funds Workshop, starting on page 3).*

*In early June, portfolio manager Steven Chamberlain discussed the management of the fund with Maria Crawford Scott.*

*What is the basic investment philosophy of the fund?*

First and foremost, bottom-up stock selection is very key to us, so there is no predetermined country emphasis or anything like that. Second, we have a bias within the fund toward growth stocks. That's really the main philosophy—we want to buy into companies that have a proven and sustainable track record, where we think earnings are going to continue to grow at least at an above-average rate relative to the average European company, and hopefully earnings are accelerating. Also, companies must have a positive earnings per share figure for each of the last six years to qualify as a growth company.

*How do you compare the stocks if the underlying companies are in different countries?*

Valuation comparisons tend to be done relative to the company's own growth rate and to its own sector. We don't distinguish between valuation levels across countries because we don't really think it is too relevant. What tends to happen is that, for example, if the Dutch markets happen to have a lot of companies with a lower price earnings ratio and at least a good growth rate, then we will be drawn to that and we'll end up overweighting the Dutch market. But we don't look at the price-earnings ratio for the Dutch index, decide that the market is undervalued, and then set out to overweight that market in the fund.

Sometimes, of course, there can be a country influence in terms of earnings per share growth. For example, for most of the 1990s GDP [gross domestic product] growth in Europe, particularly continental Europe, has been very low, and that has been the case because the countries effectively tied together their currencies and their monetary policies to get ready for EMU [the European Monetary Union]. That has been quite a disinflationary process, and a low-growth scenario has come from that. Now that we effectively are at the end of the first stage of EMU—we know the first eleven participants—we are coming out of this previously low-growth environment into a faster-growth one, particularly in certain countries—Italy, Spain, Ireland, and Portugal—that until now have been used to having high interest rates, and now they basically have German-style interest rates. Their economies are growing very quickly, and it is going to be much easier for domestic companies in those countries to grow their earnings.

*How do you find potential investments? Do you screen a database?*

We have several different approaches, one of which is a screening process. We have a database that consists of over 3,700 pan-European companies, including the U.K. We break these companies down into basically three different asset categories: growth stocks, cyclical stocks, and financials. For a company to qualify as a growth stock, it has to have had positive earnings per share each year for seven years. We then screen those that qualify as follows: We basically take the prospective price-earnings ratio—and at the present time that would be a 1998 P/E, based on consensus 1998 forecasts—and we would divide it by the compound annual growth rate of earnings per share over the last seven years. That gives us a PEG [P/E-to-growth] ratio, which is a simple way of looking at how much we are paying per unit of growth. If the PEG is below 1, we feel it is a good value. But, having said that, it is possible to get a favorable PEG ratio even though the company has a below-average growth rate. For example, if the company was trading at 10 times this year's earnings, and its compound annual growth rate was 12%, it would have a PEG of 0.8. That looks quite attractive in PEG terms, but we would much rather be paying 0.8 for a company that is achieving 30% growth even though that means its P/E would be 24. So, having a favorable PEG in itself is not enough, it has to have strong growth as well.

We rank the stocks in order of attractiveness to help identify buy and sell candidates, and then we undertake more fundamental research. Our screening process just highlights potential candidates.

*What are the fundamental characteristics you examine?*

We spend most of our time analyzing growth stocks, and what we really want to see is secular-driven growth—a company that is in a marketplace that has good growth prospects, for instance a niche market that's expanding due to deregulation or a completely new product. At the moment technology is a good example, as are financial services and telecommunications.

Having identified the size of the market and its growth rate, we will then try to identify the company's position in that marketplace—what are its strengths? What is its market share? Is that market share at least defendable or growing, and if so why? What sort of pricing power does the company have?

Pricing power is very important to us at the moment, given that we are very much in a disinflationary environment where it is difficult for companies to grow top-line, and almost impossible if that top-line growth can only be gained through pricing. Some companies have pricing power and others don't. Coca-Cola has pricing power, and Adidas in Europe has pricing power, but Peugeot does not. They have to put more and more stuff into their cars every year to get people to buy them, and at the same time, prices keep coming down. In contrast, for instance, BMW has great brand appeal to it.

We also try to identify if the company has strong research and development, how innovative it is, whether they introduce lots of new products every year, and whether the product is getting better every year, which is a good way of defending market share.

All these are things we are looking for in growth stocks, and what we'd really like to see is a company with a high return on capital employed—they are creating value for shareholders, and their free cash flow can be put back into the business which has lots of areas to further their growth.

That said, I should add that we do own stocks other than just growth stocks—we also invest in financials and cyclicals when we think it's appropriate, which normally means that we think they are undervalued and there is something taking place that is going to release that value. A good example of that is the financials, which we bought into quite heavily a little over 12 months ago, especially the banks. In fact, we are still overweighted in the banks.

*Do you use similar criteria in looking for potential candidates among non-growth stocks?*

No, we don't really look at the PEG ratio in our initial screening process, but instead look at price-to-book value. And in terms of profitability, we look at return on equity divided by the local bond market yield to adjust for local interest rates, although these days, we don't need to make that adjustment quite so much anymore, because long-term interest rates have converged and there is very little difference among markets. What we're trying to do is to determine what we call the financial value for financials—price-to-book divided by profitability, as measured by return on equity. What we hope to get is a financial value below one. We actually think that at the present time most of these financial stocks are growth stocks, but to keep things simple we still call them financials. I guess they are growth financials. In the fund, we have about 32% in financials, and 26% would actually qualify as growth stocks on the basis of earnings per share growth.

*Do you spend much time evaluating management?*

Management is big for us. We like to visit management, and what we like to see is a management that's focused on managing the company in terms of benefiting the shareholders and themselves because hopefully they own shares in the company. We like managements that have a very well-defined strategy to grow the company, and that are not going to go outside of core areas.

*You said you prefer managements that either hold shares in the company or have options to buy shares. How do you get that information—what kind of disclosure*

*requirements are there in Europe?*

That is a good question. Management is usually very open about that, and when you look at annual reports, most European companies will tell you how much management owns. In the U.K., things like that are very strictly monitored, and, for instance, if management buys or sells shares, that sort of information is given to the stock exchange immediately and then disclosed to the general public. Continental Europe doesn't tend to be quite as efficient as that. Actually, in continental Europe, share option schemes have not been allowed in many instances, and they are actually only at the early stages of allowing things like that. Daimler-Benz and, I think, Nestle recently introduced share option schemes, but Europe in general is miles behind the U.S.

*What would prompt you to sell a stock?*

The main reason tends to center around valuation concerns. If we feel that earnings growth is slowing or if we feel that we're now paying too much per unit of growth, which usually means a PEG ratio above 1.0, then we would probably sell that stock because usually we can find companies trading below their PEG rate. And where that is the case, we'd rather own those because we are getting better value.

The other reason that tends to crop up is if there is a change in fundamentals, whatever that may be.

*In terms of long-term rates of return, the U.S. market has been outperforming Europe. How do you see the European market compared to the U.S. in terms of future returns?*

The U.S. has had many things going for it compared to Europe. If we just take the last seven years or so, the U.S. has been helped by good economic growth—decent GDP growth every year quarter-on-quarter, which has obviously helped underlying earnings. At the same time, you've had companies focusing much more on productivity improvements, particularly the use of technology. Also in terms of capital allocation models, management has been much more focused on where the capital is invested in the business, what returns that capital is generating and where it has been insufficient moving it into areas of better return. So, you've had all of that going on in the U.S., and at the same time, this big boom in mutual funds as people begin to save for their retirement.

We think that we are now at a similar position in Europe, particularly continental Europe. The U.K. is somewhere between the two. First of all, economic growth in Europe has been very poor for all of the 1990s and that has been a great hindrance to companies, particularly in their ability to restructure. They have been restructuring to some extent, but it has been lost in the quagmire of dire GDP growth. Now we think we're entering into a period of decent GDP growth in Europe, as long as Asia doesn't throw a wrench into the works, which is a big question mark. But don't forget that most of Europe's trade is inter-regional rather than international.

Right now, GDP growth in Europe is accelerating because interest rates have come down markedly over the last few years, so that is helping to promote growth. The fact that the first stage of EMU is now in place has removed the big uncertainty for many people, and so their willingness to invest is increasing.

Secondly, and we think more importantly, the companies are increasingly being managed for the benefit of shareholders, and that was definitely not the case 10 years ago, or even five years ago. In the past, companies were managed for the benefit of management, of foundations, of other companies that had cross-holdings or their bank lenders. These days, though, things are changing and managements are beginning to pander to shareholder requirements—greater profitability and increased market capitalization. And the fact that Europe is opening up and becoming a true single market means that managements are under pressure to improve profitability and increase their market share, because if they don't, they are likely to be taken over, whether it be by a European company or even a U.S. company. So they are doing what the U.S. did earlier, focusing on capital allocation and then moving it from areas of low return into areas of high return, and that is structurally improving Europe's profitability. So you've got cyclical improvement and you've got structural improvement. And there is a lot of potential upside to that.

*Do you feel that European Monetary Union will be beneficial to Europe?*

We do think EMU is going to be beneficial. For some countries, it already has been beneficial in reducing long-term interest rates, although arguably that would have happened anyway because of the global environment. It is going to reduce short-term interest rates in some markets. We think that EMU generally is a disinflationary process. Going forward, now that we are going to move more toward a single currency, it will be easier to compare prices across borders, and when you can do that, it usually means that prices move to the lower level.

EMU also means that we're going to see increased merger and acquisition activity, and it has already been booming. Companies will merge or enact takeovers within their own domestic markets to become bigger because they will feel safer, and also they need critical mass in a lot of businesses.

But the biggest implication of all for Europe is this one of demographics, and this move to having to provide your own pension. All governments in Europe, even those that are more left-wing orientated, recognize that in 30 years their financial systems will be bankrupt unless they make some changes. And those changes are being made. ✦