Don’t Get Caught in the Tourist Trap

Tourist traps. Every major city around the world has them. There’s the famous restaurant where the food is actually mediocre or a street market hawking pretty trinkets that fall apart as soon as they are bought. Most of us have fallen prey to tourist traps, so we know the common theme is that cheaper and better-quality products can be found elsewhere. You just need somebody “in the know” to tell you where to go.

Investing outside the U.S. is similar. The “tourist trap” analogy may be particularly apt in Europe. There are European equities that present attractive opportunities for U.S. investors. To separate the stocks that represent true bargains from the ones that only appear to be, an expert is needed.

This is a fundamental turnaround from the past several years. During the 2008 financial crisis, many stocks plunged to valuations that proved to be unsustainably low. In that environment, bargains were easy to find. Since then, stocks have generally risen, and today there is a greater dispersion of valuations.

For example, take the price-to-book ratio, which is a balance sheet driven metric. There is a widening spread between high and low price-to-book ratios for the stocks within the MSCI Europe Index.

Exhibit A: There is a greater dispersion of valuation metrics, such as price-to-book, within European equities

Source: Bloomberg, as of August 31, 2015.

Key Takeaways

- Despite recent price action, the European economic recovery is gaining traction due to powerful monetary stimulus provided by the European Central Bank (ECB), and we believe this provides attractive investment opportunities in European equities.
- Operating margins of European companies have just begun to trend upward. We believe improving margins could extend outperformance of European stocks relative to equities of U.S. companies, whose margins have begun shrinking.
- Given the rising dispersion in valuations of European equities, and generally elevated volatility, a bottom-up fundamental approach to pinpoint the stocks that are attractively priced is required, in our view, and this necessitates the use of active management.
We believe price-to-book is a more durable metric than price-to-earnings as earnings tend to change more than a company’s capital structure over short periods.

Considering that many stocks have recovered from their low valuations, investors now need to be more selective. Not all European stocks with low valuations may be deserving of them. The same holds true for those with high valuations, especially as European stocks recover from their recent stumble. Incidentally, although year to date, the broad MSCI Europe Index is down 0.56% in U.S. dollars, the Russell 3000 Index, a similarly broad benchmark representing 3000 U.S. stocks is down 2.61% (through 8/31/2015).

Recognizing Bargains in a Crowded Bazaar

Passive investing in a fund that tracks a European equity index is equivalent to blindly buying all of that index’s constituents. The index does not cull stocks that may be overvalued or the overweight undervalued ones. It’s fair to ask: Is passive investing in a European equity index at this juncture like entering a tourist trap? What gives you better chances of getting a good deal on a quality item: an indiscriminate shopping spree through that raucous Spanish bazaar or having a local guide carefully select goods from trusted merchants?

Of course, all investing has its downside risks. Consider that the European recovery remains turbulent. It has alternated between anemic growth and bouts of recession amid the absence of fiscal reform and broad-scale monetary measures. That has made European equities volatile. However, this year the recovery has gained meaningful ground in our view. The 2015 Greek debt crisis wound up being a minor blip (despite the headlines). Greece has become simply an unfortunate exception to the fiscal reform and not a source of contagion to other European countries. Following Greece’s 2011 debt crisis, major European financial services firms and other large companies have taken steps to insulate themselves against Greece. Similarly, the current panic gripping both domestic and European markets, driven primarily by concerns about a slowdown in China and falling commodity prices, appears overblown to us. China accounts for just 4.08% of Europe’s global exports. Meanwhile, the commodity slump should benefit the region as it’s a net consumer.

Recent and unprecedented monetary stimulus by the ECB is starting to fuel bank lending and economic growth. Additionally, less developed, smaller economies like Spain and Portugal (also referred to as the peripheral countries) are following through on fiscal reform.

We expect many European stocks to benefit from the aforementioned structural reforms, but a rising tide will not lift all boats equally—especially as some boats have holes that a tourist won’t notice until they’re halfway across the Aegean Sea.

Prospects of many European companies have only just started to regain positive momentum. We believe it’s important to analyze the financial statements of individual firms to determine whether their balance sheets and growth prospects justify their stock valuations. Operating profit margins of large firms in Europe have started to rise. This is seen in Exhibit B, which depicts the trend of operating profit margins of firms represented in the Euro Stoxx 50® Index, an index of large-cap stocks in Europe. In contrast, the operating profit margins of the firms within the S&P 500® Index have started to decline. Given European economic growth, we believe operating margins of well managed companies should continue to trend upward.

Exhibit B: Operating margins of European companies could extend their recent upturn

![Graph of Operating Margins of Euro Stoxx 50 Index and the S&P 500® Index](image)

Source: Bloomberg, as of August 31, 2015.

In contrast, operating margins of U.S. companies began an uptrend in 2009 along with the U.S. economy in general. Improvement in corporate profit margins in the U.S. seems to have moderated along with the growth of the U.S. economy. It’s important to note that equity markets follow economic cycles, which show the sharpest gains during economic recoveries, which then settle into economic expansions. We put Europe in the former and the U.S. in the latter.
Exhibit C: Stocks have posted their largest gains during economic recoveries


'The three phases, expansion, contraction, and recovery are defined and calculated based on the The Centre for Economic Policy Research methodology which builds on the methodology put forth by the National Bureau of Economic Research.

Good Reasons for an Extended Visit

There are favorable conditions for Europe’s recovery. The massive liquidity pumped into the market by the ECB’s quantitative easing program (under which the ECB is buying government and private sector securities) has driven the euro dramatically lower against the U.S. dollar. That should boost prospects of European multinationals with large U.S. customer bases by making their products cheaper to buy. Examples are plentiful, like cosmetics maker L’Oreal SA, Belgian beer producer Anheuser InBev NV, and drug maker Bayer AG.

Exhibit D: The EU’s exports have risen as the EUR/USD has weakened

Source: Bloomberg, as of June 30, 2015.

From a broader perspective, gross domestic product of the European Union (EU), which has 28 member countries, has been a quarterly uptrend since the third quarter of 2014 through second quarter 2015. In that period, unemployment has fallen from 9.9% to 9.4%, and is expected to drop to 9% by the second quarter of 2016. The average economist forecast for the EU’s 2015 Gross Domestic Product (GDP) of around 2.0% would put that region’s GDP at its highest since 2011.

Exhibit E: The eurozone’s GDP growth has been rising while its unemployment has been falling

Source: Bloomberg, as of June 30, 2015.
The Value of an Expert Guide

A dynamic and diversified portfolio will take into account changing economic cycles globally. In our view, Europe’s recovery is gaining traction and creating a more attractive equity landscape, especially versus that of the U.S., which is in a moderate economic expansion.

However, since the financial crisis, we believe that Europe’s equities have recovered to the point that simple valuation metrics alone won’t tell you the stocks that will be winners or losers. Fundamental analysis of individual companies is more prudent than passive, index investing, in our view. An index fund may be the cheaper option, but it’s no better than visiting a country and using a generic guidebook to find the best deals. One may get a bigger bang for one’s buck paying just a little more to be guided by a savvy local.

The EURO STOXX 50 Index provides a blue-chip representation of supersector leaders in the eurozone. The index covers 50 stocks from 12 Eurozone countries: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. The EURO STOXX 50 Index is licensed to financial institutions to serve as the basis for a wide range of investment products such as Exchange Traded Funds (ETF), Futures and Options, and structured products worldwide.

The MSCI Europe Index captures large and mid-cap representation across 15 Developed Markets countries in Europe. With 441 constituents, the index covers approximately 85% of the free float-adjusted market capitalization across the European Developed Markets equity universe.

The Russell 3000 Index is a stock market index of U.S. stocks. This index measures the performance of 3,000 publicly held U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

The S&P 500® index is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. S&P 500 is a registered trademark of Standard & Poor’s Financial Services LLC.
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