Investing Opportunities in Europe amidst a Changing Global Economy

Summary:

- Because they're forming a government and won't default on their debt, as some fear, what's happening right now in Italy is believed to be manageably contained.
- Though overlooked, the European technology sector is prospering, especially in the area of med tech.
- Valuation dispersions within select sectors have expanded, meaning the opportunity to do stock picking is now potentially bigger.
- By leveraging the stability approach, investors can secure a very strict risk management. This may achieved by holding stocks for the long term.
- Sector allocation plays a role; it may be really a thing of the past.

Joined by Gerd Kirsten, CFA, Portfolio Manager, The European Equity Fund, we discuss investment trends and opportunities in the European market.

The following Q&A is from a discussion that originally took place as part of a podcast series on May 22, 2018.


Gerd Kirsten


Libby Hastert

Speaker 1: **Welcome, and thanks for joining us for another discussion. Today we will hear from an industry expert who shares insight on a timely issue affecting the closed-end fund space.**

LH: **Good morning everyone. I'm Libby Hastert. Today we have a special treat for you. For this discussion, we're going to travel to Europe with Gerd Kirsten from DWS, part of the Deutsche Investment Management Group. Gerd is a chartered financial analyst and CFA Institute member. He spends his days managing the European Equity Fund and working closely with his colleague Valerie Schueler, who manages the New Germany Fund.**

During the next 20 minutes or so, we're going to examine investor flows that have us looking to Europe for investment ideas. We'll also walk through the macro case for portfolio exposure to the European market and consider how these markets may benefit from the application of active management.

Lastly, we're going to zero in on Deutsche's bottom-up stock selection process, identifying where Gerd sees accessible opportunities in today's market.

Now, without further ado, I'd like to turn things over to today's market guide, Gerd Kirsten. Gerd, you've been managing various funds for over two decades now, most recently working as portfolio manager of the European Equity Fund in the Deutsche family of closed-end funds.

So this fund seems to be broadly invested across the various sectors in European countries. Can we start with the macroeconomic picture in Europe? Are there some shifts politically in the region, in Brexit, that are still being worked out affecting that? Really, and more broadly, how is Europe positioned to compete and grow going forward? Gerd, can I turn things over to you?

GK: Yeah, those three points are really critical to set the framework here. Let's get one thing out of the way first, which is politics.

Obviously, you have a lot of media hype when events like Brexit happen. Currently, it's Italy. But I don't think I have to tell Americans that if you have crazy politics it does not mean the economy can't grow, and the stock market can't rise.

What's forgotten, often, is that Europe actually is on a structural reform path. The EU is improving. There is a lot of pressure after Brexit to reform Brussels, to streamline it. France has been a good example of how reforms have happened. So things are happening.

Then, the other thing you mentioned, macroeconomic environment. Whenever we have a global recovery, a synchronized global recovery, which we are having right now, Europe is one of the best regions to have, if not the best, because we are very export-oriented. We depend on growth in America, in China, in the emerging markets. That's where growth is coming from so we very much levered toward that.

The third point you mentioned, competitive advantage, there are certain industries, well known, not just us Germans, but well known throughout the region for good engineering. Not just building cars, which has become a much more global business, but very much in the machinery area. Also in the technology sector, very much underrated often here in Europe compared to the US, but it's a prospering technology sector, especially also on the medical side. Where the US is obviously dominant in biotech, we have amongst the best med-tech firms.

So the competitive environment is a good one. We've got a labor force that's very accessible, well educated, and that has good wages, so the overall competitive positioning of Europe is improving.

LH: For those listening you know, we sometimes speak about Europe as a single entity, but really it's a diverse group of countries. How important is country allocation to your portfolio? Or are you more driven by individual stock selection?

GK: Yes, over the last 10, 20 years that has really changed in that because, what I was talking about, the advantages of the common market, the composition of what we have, that we've grown together. That's why country allocation is much less important. It is important for risk events, but we've evolved in terms of our investment process. Country allocation is a thing of the past. Sector allocation plays a role, but it's also really a thing of the past.

What we want to focus on is trying to get the best bottom ideas that you can get. So try to be as unconstrained in the initial process of screening ideas and discussing ideas, and then concentrating the portfolio. When we do like a stock, we take strong bets there.

When you have such an approach, what's very important is at the other end, on your risk management, that you look at those factors that you do look at. That's what we do, we have to mark the most sophisticated risk models. We do look at: do we have a country tilt? Do we have a sector tilt?

But then we also go beyond that and we look at various investment factors. Do we have a quality tilt on our portfolio? Do we have a momentum tilt? Defensive versus cyclical? So that's really around the whole risk management area

If we do have risk that we don't want, then we'll adjust the portfolio. So I think the whole idea is to get the best ideas into the portfolio with big weights, and then, certainly, have very diligent risk management.

LH: **With the diversity of countries and companies in your investment universe, do you feel like there's an advantage to having an actively managed fund?**

GK: Yes, certainly. Especially in Europe, where everything is not quite as efficient as they may be in top developed markets like the US. Starting with the investment universe, typically on the passive side when you track indices, the DAX index has 30 stocks, the EURO STOXX 50 has 50, and then they go up to a couple of hundred.

But what we look at is over 2000 stocks that we screen. They're all liquid. Europe has, certainly, more than 2000, but 2000 stocks that we screen that are liquid enough for our portfolios. That's our investment universe to start off, so that's much bigger.

The second point is that we take very dynamic weightings in our portfolio. That means, as I said before, it's very concentrated portfolio. We want to have each of these ideas to have a strong impact in terms of performance. You don't have that if you have passive strategy.

The third thing is a bit more sophisticated, but it is a real opportunity now, and that's the dispersion of valuations within each sector, within each subsector. For example, if you have industrial stocks and they all trade around the same multiples, it's very difficult to do. You can do some picking, but the opportunities of different returns going forward are difficult.

What we've seen is that these valuation dispersions have expanded and that the opportunity to do stock picking is bigger now. That usually is a phase when actively managed fund perform much better.

LH: **In the case of European Equity Fund and the New Germany Fund, it seems that stock selection is critical to really building those portfolios. Can you discuss the key factors in your investment process that lead to a company making it into these portfolios?**

GK: There are a number of very strong pillars that we work with. First of all, it's certainly the people involved. We have probably one of the biggest European equity teams managing funds, with 30 fund managers. We're not only located here in Frankfurt. Actually, it's a big advantage to be very local. We're located in Frankfurt, in Switzerland, in Spain, as well as in the UK.

I think a big advantage over our competitors who mostly sit in London is that we are on the ground. We can kick the tires here. We speak the language. We're not only German but we speak French. We have Italian, we have Spanish colleagues. That's a real advantage when we talk to management.

That's really the second part of our investment process: you need a good team but you need to do your homework. We need management. We have about 1600 management meetings every year. We really drill down. We try to pinpoint the key issue before we go into these interviews, then we're very tough with company management, trying to find out whether there is momentum in the business, were there any risks involved. That's a key thing, really, to kick the tires there.

Then the third thing is even if you have a good team and you do your homework, you have to know what the market is saying and what the consensus is. Otherwise, you have the same opinion as everyone else, and if everyone is already positioned that way, you won't make much of a difference.

So the third step is really that we're very conscious of what the consensus is for both the sell side, as well as the buy side. How are sell-side brokers rating these stocks?

If everyone has a buy on it, do we really also want to buy it? And we look at the sentiment changing. When earning revisions are changing positively, we like those turnaround points.

That's a core part of our investment philosophy: we don't want to fight the market. We want to see where there are opportunities to add value. Where are we different from the consensus? I think those three points really make the difference.

LH: Earlier we touched on active management, and I think you really showed how instrumental your team is with these two funds, but for EEA and GF, what do you believe important advantages are for these two funds?

GK: On EEA we use an approach that we call the stability approach, which really helps it give a very asymmetric risk return profile. What do I mean with that? We call it stability because it's not that we buy uniquely low-risk stocks. That's not the low-volatility approach that some funds have.

How do we do that? Very important here is the screening. We screen according to investment factors. We use quality. We use value. We use growth and momentum. There are a number of factors behind that to initially screen, and which factors make sense in which investment phase.

That changes, and that's why we use the screening which helps us then to focus. Which companies do we want to talk to? Which ones do we want to analyze more closely and then take into the portfolio?

Now, before we take one into the portfolio, we also have a quality filter which entails looking at how volatile earnings have been in the past, how often do the companies deliver negative earnings surprises and a whole host of other factors.

And then the last thing: I mentioned risk management earlier. With the stability approach we have a very strict risk management. We like to hold our stocks for the long term, and then the result, as I mentioned, is asymmetric.

On the other hand, New Germany is very focused on, obviously, a single country, and is focused on small and mid-caps. So that investment universe is highly attractive in itself. Germany is showing persistent competitive advances within Europe, so that's very attractive.

And finally, for New Germany, it's an even more concentrated portfolio. If you look at the top 10 holdings, they're about 50% of the total portfolio so you get a very active fund here.

LH: You spoke about how both of these funds can play a key role in both bear and bull markets, but in recent periods US investors have been adding exposure to Europe as a potentially better value than the US equity markets. Outside of these funds, do you think it's still timely for US investors to add diversification with European equity exposure?

GK: Yeah, excellent question. I'd say it's actually more than timely. We look at these long-term trends. We look at valuation differentials and we look at earnings growth differentials. With the conclusion that we have right now, if you just look at valuations, first of all, if you take the cyclically adjusted P/E ratio, also known as the Shiller P/E, we're actually at a 40-year high discount for Europe versus the US.

It's similar if you take a price-to-book or a dividend yield. We actually have a record gap in terms of the dividend yield that European companies pay versus what you get on government bonds or on corporate bonds. There's a very nice spread.

So that variation and having record variation gaps is always a very good starting point. Now, the key is what can happen. What will make a change? What will make the gap close? That's where from the US point of view you have also to consider, of course, that within the US, or whether the US equity outperforms come from.

Obviously, some of the more recent factors are more than priced in now. The technology rally, as I said, technology has a much bigger weight in the US than it has in Europe. In Europe, it's expanding, though, and that rally is certainly not the youngest anymore.

The other factor for the US that was very beneficial was certainly the corporate and personal income tax cuts, and the gross boost that's happening right now. But, equity markets have certainly priced that in, as well.

On a relative basis, then you have to compare it with what's happening in Europe. There you have to say, "Well, is the structural framework, is it that different?" Yes, the US has some advantages in terms of having less red tape, but even regulation has exploded over the recent 10 years. The current administration is trying to lower that. I mentioned Europe, the regulation is complicated but also reform is happening, so that's about even.

But one thing that definitely makes it very likely that the gap is going to close is the cyclical factors. Europe is, as I mentioned, very much geared toward exports. And what are the key export markets? Amongst the ones with the highest differential growth are emerging markets, and we've had a lull. The number of companies that even China, which has the fastest growth, had a slowdown. That's re-accelerating.

We've had things like the Russian crisis, also a big market. That's stabilized. Brazil was horrible, in a horrible recession. That's stabilized. India is performing well. So as a European investor, you have to have a very global view. When you see all these markets stabilizing or re-accelerating then you see our export companies will benefit and we get them at much cheaper valuations than you get similar US companies.

The other point is the recent oil prices. The oil price right now is actually beneficial, more beneficial for Europe. It may seem counterintuitive at first, but we've seen a lot of our companies, there's a big energy sector here by the way, and then we see a lot of that positive inflation coming through into the chemical space. We see pricing power there, especially this accelerating into 2018 now.

Overall, in sum, we expect earnings to grow double-digit this year. They did grow double digit last year after having a lull of many years of close to 0% growth. This would be the second year of double-digit earnings growth and at the end of the day, that's what it's all about in order to get an investment return.

LH: **Thank you, Gerd. I think you gave investors, both in the US and globally, a lot to think about. You made a great market guide and I appreciate you walking us through a complex but really exciting European equity market. I look forward to hearing more and seeing how this plays out.**

Speaker: **Thank you for joining us. We hope you will stop by again for news on this every changing space.**

Disclaimer
On or about July 2, 2018, Deutsche funds will change their name to DWS funds and Deutsche Investment Management Americas Inc. will become DWS Investment Management Americas, Inc

Opinions and Forecasts Disc: The opinions and forecasts expressed are those of DWS as of May 2018, and may not actually come to pass. This information is subject to change at any time, based on market and other conditions and should not be construed as a recommendation of any specific security.

For purposes of ERISA and the Department of Labor's fiduciary rule, we are relying on the sophisticated fiduciary exception in marketing our services and products through intermediary institutions, and nothing herein is intended as fiduciary or impartial investment advice.

Risk information
Investing in foreign securities, particularly of emerging markets, presents certain risks, such as currency fluctuations, political and economic changes, and market risks. Any fund that concentrates in a particular segment of the market or a particular geographical region will generally be more volatile than a fund that invests more broadly.

Obtain a Prospectus
To obtain a summary prospectus, if available, or prospectus, download one from www.dws.com for more information regarding the fund's objectives, risks, charges and expenses.

Investment products offered through DWS Distributors, Inc. Advisory services offered through Deutsche Investment Management Americas, Inc.

Investment products: No bank guarantee | Not FDIC insured | May lose value

The brand DWS represents DWS Group GmbH & Co. KGaA and any of its subsidiaries, such as DWS Distributors, Inc., which offers investment products, or Deutsche Investment Management Americas Inc. and RREEF America L.L.C., Which offer advisory services.

DWS Distributors, Inc.
222 South Riverside Plaza, Chicago, IL, 60606-5808
www.dws.com service@dws.com
Tel (800) 621-1148

Disclosure
Closed-end funds trade on exchanges at prices that may be more or less than their NAVs. There is no guarantee that an investor can sell shares at a price greater than or equal to the purchase price, or that a CEF›s discount will narrow or be eliminated. CEFs often use leverage, which increases a fund›s risk or volatility. The actual amount of distributions may vary with fund performance and market conditions. Past performance is no guarantee for future results.