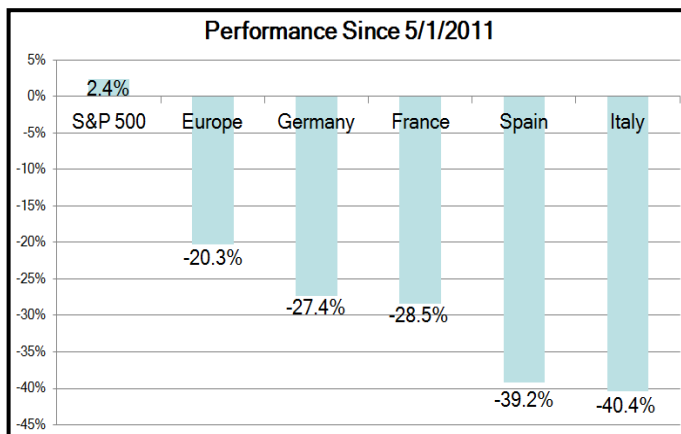


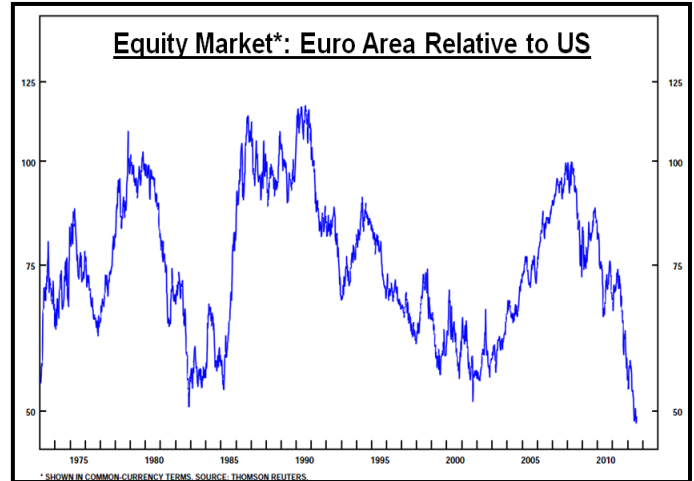
**Introduction**

In has become a well worn cliché that with every crisis there comes an opportunity. Certainly in the investment field this homily has a ring of truth. The three large financial crises of the last fifteen years all created large opportunities for investors. The Asian financial crisis, the bursting of the tech bubble, and the mortgage crisis all created good opportunities for those investors who kept their head while others were panicking. If we think back even further, in the early 1980's global equities were spurned by all but the thickest skinned of investors. Equities as an asset class had been dubbed 'dead' by BusinessWeek. As a consequence valuations on US equities reached lows rarely seen in the twentieth century. In retrospect this presented an unusually good buying opportunity and equities went on to deliver generous returns over the next couple decades.

Baron Rothschild is reputed to of said that the best time to buy is when there is "blood in the streets." Whether he was being metaphorical is not known, but if you look around the world today investors in Europe are clearly bleeding. European equities have massively underperformed US equities and markets in counties such as Spain and Italy are down roughly 40% since May 2011 (through the end of July). Even the German market is off over 27%, as you can see below.



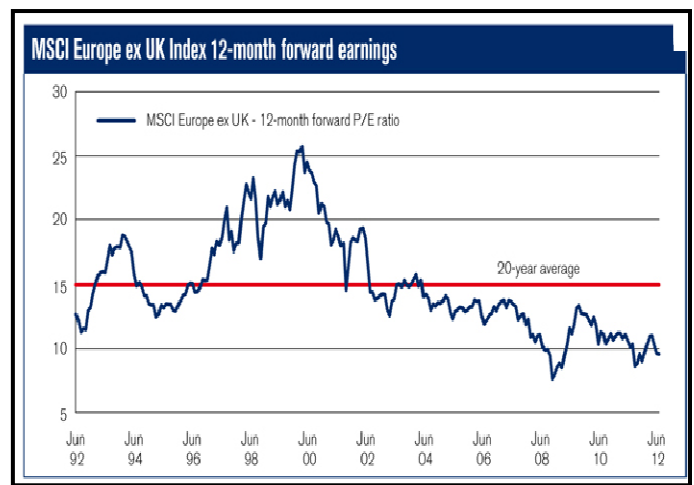
However, European equity underperformance really began much earlier. The chart at the top of the next column illustrates just how much European equities have underperformed US equities since 2007 (a falling line indicates European equity underperformance) We are at an all time low in terms of relative performance.



Our portfolios have benefited from this trend as we have been underweight Europe since 2008. However, does this extended chart mean European equities are about to start a multi-year period of outperformance? Should we be adding European equities to our portfolio to bring our allocation closer to neutral? In our mind there are two key issues in answering this question. The first concerns valuation – are European equities cheap or expensive? Secondly, if stocks in Europe are cheap, what is the catalyst that will lead to a turnaround in relative performance? We attempt to answer both questions below.

**Absolute Valuations**

There are numerous ways to look at valuations. The chart below shows the forward price-earnings (PE) ratio on European equities going back to June 1992. European equities sell at roughly 9 times forward earnings, well below the 20-year average of 15 (a 40% discount).



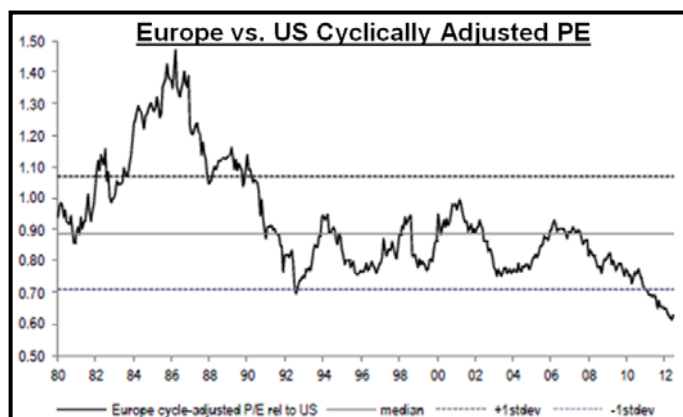
The problem with forward earnings measures is you simply cannot know with much certainty if the estimated earnings in the model will actually materialize. This is certainly true in Europe where parts of the region are in near depression status. Another way of looking at valuation is to use trailing earnings. A relatively conservative way to do this is to look at an average over the last few years earnings to try and smooth out economic cycles. The chart below shows the seven-year cyclically adjusted PE ratio for both Europe and the US. As you can see, on this measure Europe trades at roughly 10 times trailing earnings while the US is close to 20 times. Europe is about as cheap as it has been since 1983. The US is far from it.



Both forward and trailing PE measures deal with absolute valuations, but to some extent we are more concerned with relative valuations. Our approach to allocating assets is to utilize a broad asset allocation but also to tilt the allocation in the direction of relative valuation. For example, in late the 1990's we tilted away from growth and in favor of value due to the excessive valuation of growth stocks and the outright bargains in other sectors. Is the situation similar today?

**Relative Valuations**

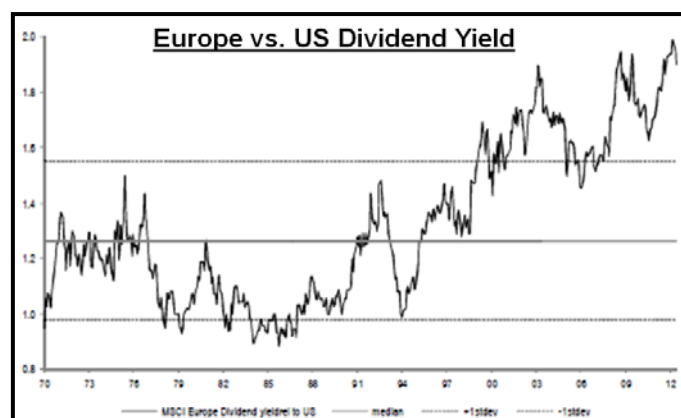
The next chart shows the relative valuation of Europe versus the US based on cyclically adjusted earnings. As you can see, Europe has not been this cheap relative to the US in the last 22 years.



It is a similar story when you look at price-to-book ratios. Rather than using earnings, which tend to be awfully volatile, this measure looks at book value - the value of a firm's assets less its liabilities. Again, European stocks are about as cheap as they have been since the mid-1970's.



Finally, let's look at dividend yields. We are all familiar with the rush into dividend paying stocks in the US. However, dividend yields are much higher in Europe. As the chart below shows, dividend yields are on average twice that of the US, a ratio not seen in the last 42 years.



The conclusion of all this is that European equities, on most objective measures, are cheap. But what is cheap today can get even cheaper tomorrow. So the critical question is what are the catalysts that will turn around the performance of European equities relative to the US?

**Identifying the Catalysts**

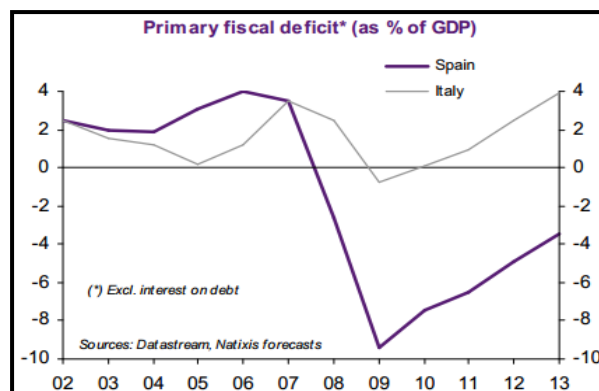
We won't spend time rehashing the bearish case for Europe. The crisis in that region has been simmering for over two years and much ink has been spilled on the problems and challenges facing that area. We have been underweight European equities since 2008 and benefited from the large underperformance of Europe relative to the US. However, all trends come to an end, and as the very first chart in this analysis shows, when relative performance shifts in favor of European equities the

trend could last a number of years, especially considering the attractive values offered in Europe.

We would contend there are two facets to answering the question of what it will take to end European equity underperformance. The first point is what most investors tend to focus on – what will it take to solve the crisis. In reality this is an awfully high hurdle. We think the solution for the European debt crisis is in theory very simple, but in practice rather difficult to achieve. Ultimately we think the risk in each individual sovereign bond market has to be mutualised across the whole euro area. This means countries cross guarantee each other's debts in one way or another. This could entail a full fiscal union or some watered down version. However, without this Europe's economic and monetary union is inherently unstable and this instability is likely to feed on itself until the system breaks down. Such a solution is going to take years to materialize as the political process evolves in a number of countries.

In our mind it will not take an outright solution to lead to a turnaround in European equities. We simply need to see the risk of a disorderly breakup/debt default disappear. This is a much lower hurdle and last year's Long Term Refinancing Operation (LTRO) provides a hint of what is needed. In late 2011 the European Central Bank (ECB) announced the first of two programs designed to provide liquidity to the banking system. The ECB provided three year financing to European banks to compensate for deposit outflows. Ultimately they lent out over 1 trillion Euros to the area's banks. The market welcomed this initiative because it lessened the chance of a major left tail event, namely massive bank failures in Europe and possibly around the world. However, the markets faltered in the second quarter as it became evident that the sovereign credit of certain governments were still a problem.

We suspect what is needed for a turnaround in European equities is a mechanism to stabilize sovereign credit quality in the same way LTRO stabilized bank credit quality. And the key to stabilizing sovereign credit quality for all but Portugal and Greece is bringing borrowing rates down to more manageable levels. We would contend that both Spain and Italy remain basically solvent. By this we mean at reasonable borrowing rates and modest growth levels both countries can service their albeit high debt loads. For example, the Italian government runs a 4% budget surplus before interest payments, as you can see to the below.



Certainly the deficit in Spain is larger, but we think comparing Spain and Italy with Greece is misguided. Greece is essentially bankrupt regardless of its borrowing rate. Both Spain and Italy are only bankrupt if the market forces borrowing rates so high that interest expenses goes through the roof. Furthermore, neither country has to grow particularly quickly to manage its current debt load. At reasonable borrowing rates both countries can manage their finances at real growth rates of roughly 1% per year. The key is to bring punitive borrowing rates down to more manageable levels. And as with European banks, the ECB is the key player in this saga.

### The ECB is the Key

Any plan to stabilize the markets will entail the ECB being an active participant. They are the only entity with room to maneuver and basically unlimited firepower. While a fiscal union will take years to hash out, some form of debt mutualisation is possible in the short-term through the ECB. For example, the ECB could commit to buy unlimited amounts of distressed bonds, it could set an upper limit on sovereign yields, or the two bailout facilities (EFSF & ESM) could become a bank and expand their firepower with full access to the ECB's balance sheet. All of these ideas would likely drive down sovereign yields and lessen the odds of sovereign defaults.

And on this score there were at least signs of hope in the first week of August as the ECB announced plans to support troubled countries. ECB president Mario Draghi said the ECB is open to buying sovereign bonds in the open market to drive down financing costs under certain conditions. This plan would be triggered when a nation requests aid from the EFSF or the ESM. This is a necessary condition in Draghi's view because working through the ESFS/ESM would require the country in question to commit to a series of fundamental reforms (budget reform, austerity measures, labor market reform, etc). This is the famous conditionality demanded by Germany. Crucially, Draghi also stated that market participants' concerns about any seniority enjoyed by the ECB (a major problem in Greece) as a sovereign creditor would be addressed.

In our view the ECB is trying to walk a difficult path. On one side of this path is the quagmire of fiscal dominance. If the ECB does too much to support sovereigns, appropriate adjustments may not take place and the region may slide into chronic monetization of deficits

and debt. One the other side of this path is the cliff of Euro breakup. If the ECB does too little, then the monetary union will unravel.

We believe the ECB's tentative plan is a constructive step forward as they will have a mechanism to keep sovereigns in the capital markets in a way that ensures conditionality. Of course there are dissenters. Bundesbank president Jens Weidmann does not support the ECB decision. Weidmann clearly feels that the ECB's independence is under threat and that the central bank is under enormous pressure to act in order to compensate for the failure of the fiscal authorities. He does have a point. In many ways this crisis has turned into a high stakes game of brinkmanship between Germany and the periphery regarding fiscal burden sharing, and between the ECB and the periphery regarding monetization.

There are clearly problems with the ECB's new plan. Because countries will only receive help once they have applied for aid from the EFSF/ESM bailout facilities, ECB support will be strictly conditional on hitting austerity targets. This will simply reinforce the deflationary cycle in place today.

Another problem concerns what happens if the leaders in either Spain or Italy don't ask for a bailout. If either leader accedes to domestic pressure and lets up on austerity measures, the crisis will worsen. We suspect Spanish and Italian sovereign yields are likely to spike higher before further action is taken because leaders in these two countries will need to be forced to act. However, the key is that the authorities in Europe are finally developing a plan to deal with sovereign credit quality. The path towards implementation is going to be rocky, but the commitment to implement the plan looks to be there.

### **Conclusion**

As we laid out above, from a valuation perspective we are reaching the point where investors are likely to be well rewarded in the years to come by owning European equities. The question concerns timing and identifying the catalyst for change. What needs to take place to realize this value? If we buy European equities today will we have to wait a number of years before we finally see a turnaround? Unfortunately there is never a clear and easy answer when trying to predict the future.

Buying equities in 1982 only seems like a good idea in retrospect. There are many examples of investors buying cheap assets only to see them get even cheaper as prices fall. Value investors buying small-caps and REITS in 1996 and 1997 or the move into beaten down financials in the middle of 2008 are but two of many examples. However, as asset allocators with a major overweight allocation to Europe, we need to consider what it will take to move us closer to neutral in the region.

We argued earlier that it will not take an outright solution of the European debt crisis for European equities to bounce back. It will simply (or not so simply) take a commitment on the part of the ECB to stabilize sovereign credit quality by controlling borrowing costs. This would halt the negative self reinforcing spiral currently in place. Without question peripheral Europe will be struggling with anemic growth and deflationary pressures for quite some time, but markets are priced at the margin. Only a few weeks ago the prevalent fear was that Europe was going to disintegrate. Any tempering of this fear will likely be positive for risk assets globally, and European assets in particular.

So what is our strategy concerning European equities? We think the ECB announcement in the first week of August is a step in the right direction. We are currently overweight Europe at this time, but we are adding a very modest position to European equities in the Risk Zone 6 (60% equities/40% bonds) and above accounts. Our plan is to dollar-cost-average into a full position over the next few months if the situation continues to improve. We are likely to find out more about the ECB's intentions on September 6<sup>th</sup>, and we wouldn't be surprised if the markets test the ECB's resolve again by pushing Spanish and Italian bond rates higher and the markets lower. However, if the ECB proves true to their comments and does step in, we are inclined to add to our allocation on any dip. This will entail adding to international funds or ETF's in increments over time to bring our overweight allocation closer to neutral. Our short-term timing may very well be off, but the long-term valuation case today is compelling enough to make us want to unwind our large overweight bet on Europe if we see concrete action on the part of the ECB.

***Charles Blankley, CFA  
Chief Investment Officer***

---

The material presented (including all charts, graphs and statistics) is based on current public information that we consider reliable, but we do not represent it is accurate or complete, and it should not be relied on as such. The material is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. It does not constitute a personal recommendation or take into account the particular investment objective, financial situations, or needs of individual clients. Clients should consider whether any advice or recommendation in this material is suitable for their particular circumstances and, if appropriate, see professional advice, including tax advice. The price and value of investments referred to in this material and the income from them may fluctuate. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Fluctuations in exchange rates could have adverse effects on the value or prices of, or income derive from, certain investments. No part of this material may be (i) copied, photocopied or duplicated in any form by any means or (ii) redistributed without the prior written consent of Gemmer Asset Management LLC (GAM). Any mutual fund performance presented in this material are used to illustrate opportunities within a diversified portfolio and do not represent the only mutual funds used in actual client portfolios. If you would like a complete list of mutual funds used in an actual client portfolio, please contact our office. Any allocation models or statistics in this material are subject o change. GAM may change the funds utilized and/or the percentage weightings due to various circumstances. Please contact GAM, your advisor or financial representative for current inflation on allocation, account minimums and fees. Any major market indexes that are presented are unmanaged indexes or index-based mutual funds commonly used to measure the performance of the US and global stock/bond markets. These indexes have not necessarily been selected to represent an appropriate benchmark for the investment or model portfolio performance, but rather is disclosed to allow for comparison to that of well known, widely recognized indexes. The volatility of all indexes may be materially different from that of client portfolios. This material is presented for informational purposes.