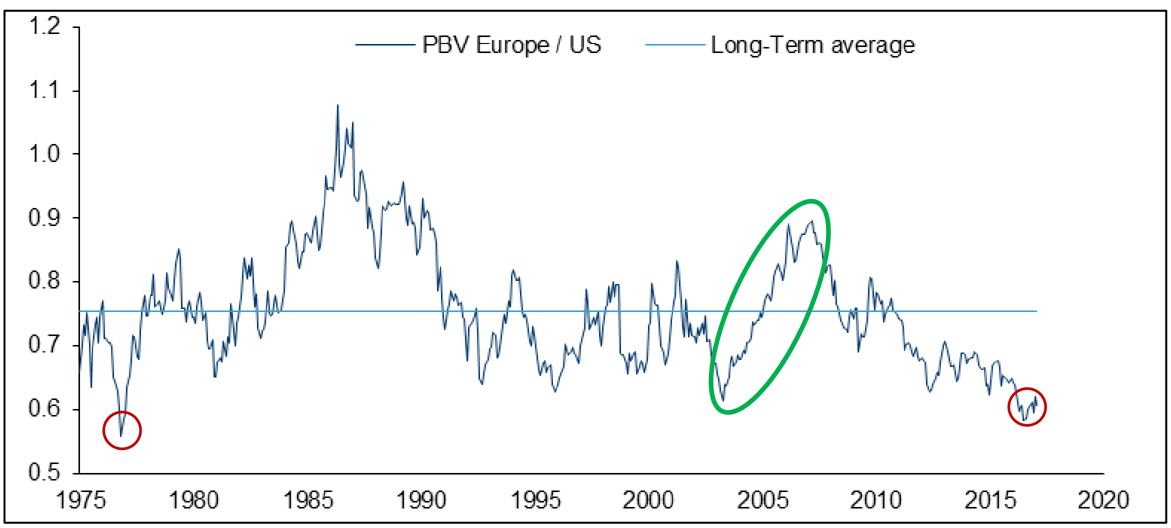
European Long/Short Equity – No Time Like the Present

May 2017

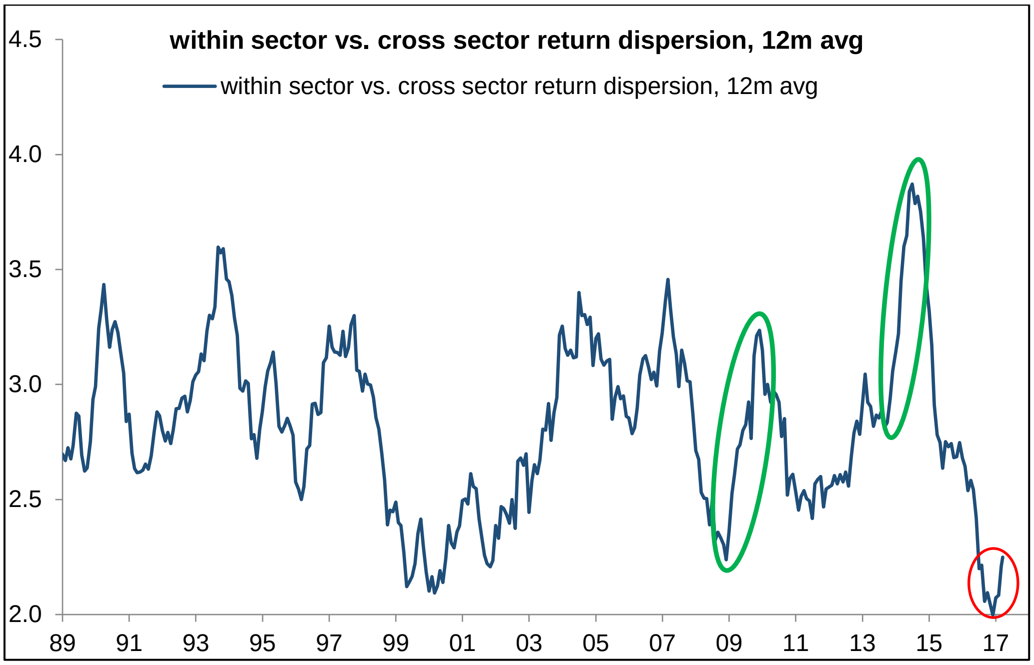
European equity markets arguably present the best opportunity in developed equity markets at this moment. We are currently observing both cheap valuation and widening dispersion in the region. While bargain valuations or rising dispersion individually may be an emerging indication of potential opportunities for those willing to roll up their sleeves, the combination of the two occurring in unison signals a particularly attractive investing environment on both the long and short sides for active managers. Coupled with underwhelming support from global investors and exaggerated political pessimism, history tells us that there is a potential opportunity with respect to European equities.

As can be seen in the chart below, the price-to-book of European equities relative to U.S. equities is as low as it has been in 40 years dating back to 1976. The last time we saw a prolonged period of outperformance was from April 2003 through May 2007 (seen in the green oval below), when the MSCI Europe Small-Cap Index outperformed the S&P 500 Index by more than +265%. The valuation point today, indicated below in red, is even more attractive than it was then.



The market environment for stock picking is also ripe for improvement as seen in the return dispersion chart below. Dispersion is the degree in which stocks move in unison or independently. Higher dispersion is better for long/short equity strategies as the manager has a greater likelihood of finding winners and losers. Active management tends to perform better during periods of high dispersion. During the period of December 2008 through October 2009 dispersion increased from 2.2 to 3.2, meaning stocks began moving increasingly more independent of one another. During this period, the Balter European L/S Small Cap Fund (BESMX) returned +41.9% compared to 37.79% for the STOXX Europe 600 Index while maintaining an average net exposure of 59%. Similarly, from August 2013 to June 2014 dispersion increased from 2.8 to 3.9, with the Fund returning +24.9% and the STOXX Europe 600 Index +20.8%. The Fund's average net exposure during this period was 74% net long.

As indicted in the red oval in the chart below, dispersion is beginning to pick up from historically low levels. Since this began in September, the Fund has returned +8.93% compared to +3.55% for the STOXX Europe 600 Index. If this trend continues, we expect an extremely favorable environment for active management.



The opportunity to invest European equities has rarely been as attractive as it is today. With the tailwind of low valuation and rising dispersion we believe the opportunity is ripe for active management to shine in the coming months and years. Factors have aligned to make now a very good entry point for long/short investing in European equities.