



Charles Lahr

## Mergers, Cost Cutting, Regulation: Opportunities and Challenges for Equity Investors

*There are plenty of things for equity investors to consider these days, from market swings in the U.S., to governments groaning under debt loads in Europe, to currency fluctuations affecting exporters in Asia.*

*In the final of a series of Q&A articles accompanying the recent release of PIMCO's Secular Outlook, portfolio manager Charles Lahr discusses opportunities and risks across global equity markets.*

**Q. Companies have improved their earnings and balance sheets since the financial crisis. Is there room for further improvement? And what does PIMCO's view that consumers are more debt averse mean for the bottom lines of these companies?**

A. In select cases, as always, companies will have the wherewithal to improve their earnings outlook and balance sheets. Regarding the second question, consumers being more debt averse might imply a few things. For instance, one would expect the top line of companies in cyclical industries to suffer as a result, particularly those companies that are levered to consumer cyclical behavior. Yet, as we know, many corporate managers are rewarded on the basis of their company's equity value, and, thus, we are likely to see management

of economically sensitive companies squeeze their top lines – restructuring costs to get a higher proportion of sales to flow down to net income – and also engage in more mergers and acquisitions (M&A).

M&A is likely to be an interesting area going forward, especially here in the U.S., where a lot of companies already are lean, and the only way really to create further synergies may be via consolidation. Companies in this situation potentially will look for overlapping market exposure, distribution, headcount, etc., and I would expect that – provided we avoid a double dip recession scenario – we may be at the beginning of a substantial rise in the M&A cycle.

**Q. What else can you say about the outlook for companies in different regions and in different sectors?**

A. There is one overarching theme that I think is very interesting, given equity markets today: Europe is clearly an area where value investors should be dedicating some time and effort. Many equities in Europe are down for the right reasons, including exposure to sovereign debt

in problematic nations like Greece, Portugal or Spain. However, plenty of other companies are not exposed to sovereign risk thanks to their substantial foreign operations and other factors, yet they have been down substantially with the overall market in Europe, trading at meaningful earnings multiple discounts to their U.S. counterparts. Also, as long as stocks remain depressed in Europe, their dividend yield in aggregate could be about double that of the U.S., providing a more attractive level of current yield.

So, at this time, there is a real potential benefit to focusing on individual companies, looking at their balance sheets, and if you are a long-term investor, buying names cheaply in Europe with the potential to appreciate over time as the market learns that these names actually aren't that exposed to the negatives of Europe.

**Q. What about emerging markets? Does PIMCO's long-term view of slower economic growth in developed nations and stronger growth in emerging ones suggest the best opportunities for equity investors are in emerging markets?**

A. Not necessarily. Looking ahead, we think equity investors are likely to generate the greatest alpha, or excess return, by buying the equities that are most undervalued and that's not necessarily in emerging markets. Sometimes stocks have very optimistic outlooks built into their prices, including anticipated growth in earnings; and, certainly, the sun is shining on emerging markets on a number of top-down, macroeconomic levels. But it's our view that one has to find individual opportunities and

determine what, if any, discount to the real value of a company is inherent in the stock price. We're looking for securities trading for 60 cents that we believe are actually worth a dollar. While it's still possible to find equities like these in the emerging markets, you tend to find fewer of them in markets with such buoyant outlooks.

**Q. Looking across markets, we have seen a lot of volatility in stock prices. Is all that a reaction to the fiscal woes on display in Europe? Or does it also suggest investors are seeing eye-to-eye with PIMCO on slower growth in developed countries as consumers and businesses reduce leverage?**

A. I think it's both. I believe investors are deeply concerned about issues in Europe, including the lack of fiscal unity and the inability to get one message from one voice out of European bodies to decisively quell unease over sovereign debt. European leaders are taking some important measures, but investors appear to be saying those moves are not fast enough or decisive enough, and some investors may fear a global drag on growth. (Read more analysis on the situation in Europe in an interview with portfolio manager Andrew Balls on PIMCO's global Web sites.)

**Q. How might financial reform affect companies and consumers?**

A. The takeaway, in short, will likely be less availability of credit. Beyond that, with different proposals in different countries, an unlevel playing field may emerge across borders, generating alpha opportunities for an active equity manager. Whenever regulation is

escalated at the political level, inefficiency can result, as evidenced by the roughly 2,000 pages of the financial reform bill in the U.S. – the longer the bill, the greater the potential for unintended consequences.

A much simpler way to address many of these issues would be to focus on higher capital requirements for lending institutions. Capital is rather foolproof in enhancing a company's ability to absorb risk or losses. However, that said, the result would be the same: less availability of credit to consumers and companies.

#### **Q. Additional thoughts?**

A. Market volatility could make investors uneasy, but this is a great time to be a value investor, because volatility tends to beget

opportunities over the long run. Many companies get sold for the wrong reasons, and if you have the ability to go in and identify individual names that are being undervalued by the market and make prudent investments, you're likely to find some very attractive opportunities.

#### **Thank you, Charles.**

*Charles Lahr and Anne Gudefin are portfolio managers heading the recently launched PIMCO Pathfinder™ Strategy, an actively managed global deep value equity approach focused on steeply discounted stocks of fundamentally strong companies.*

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