August 3, 2012

Dear clients and colleagues,

European markets have once again been quite volatile so far this year. After a surprising return of +16.7% in the first quarter, MSCI Europe Small Cap index plunged 7.3% during Q2, underperforming both North American and Pacific regions. With global economic uncertainties and an ongoing European sovereign crisis, investors have increased their exposure to bonds and cash to the detriment of European equities.

Although no quick fixes can resolve this deeply politicized sovereign crisis, recent developments in Europe are moving in the right direction. Overall we feel cautiously optimistic for European small companies. We think that the disconnect that exists between stock valuations and company fundamentals should revert back eventually.

At the corporate level, European companies have benefited from a weak euro. Companies that generate a significant portion of their sales abroad have experienced a positive translation effect on their top line while improving their cost base.

Several European companies we follow closely have reported better than expected results for the first six months. On average, their international sales growth has more than offset the weak demand observed in their Southern European markets.

With double digit earnings decline already priced into the stock markets, sentiment and valuations look too depressed. Most European markets are currently trading below 10x forward Price to Earnings ratio, a level that hasn't been seen in 30 years.

While all eyes are on Europe right now, we feel that investors may become increasingly worried by the upcoming U.S. fiscal cliff or the more pronounced slowdown in some emerging countries. If this scenario occurs, investors might gradually reallocate into high quality discounted European equities.

European companies held in our portfolios offer strong corporate governance and are internationally oriented, two attributes that we highly value. Over time, most of our European companies have been successful in diversifying their sales overseas. While taking into account the ten biggest European holdings across our portfolios, we observe that, on average, companies are generating 55% to 58% of their revenue outside Europe and UK.

Our investment philosophy prioritizes companies that offer above average industry growth with good free cash flow levels and strong balance sheets. Our approach has delivered good performance results in both up and down markets. Thanks to a strong security selection, our European holdings have outperformed the benchmark by 5.5% during the first 6 months of 2012.

Going forward we still see plenty of investment opportunity in Europe. We believe that long-term investors should definitely be exposed to this region in order to be well positioned for the expected regional turnaround. If an unexpected resolution to the crisis emerges, small European companies are likely to bounce back significantly. In the meantime, we trust that policymakers will take all the necessary steps to reassure investors about the long term viability of the Euro.

Have a nice weekend.

The Global Alpha team