Global Perspective

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Since the financial crisis, a yawning performance gap has emerged between the US and European equity markets—nearly the largest in 20 years. And yet, traditional explanations of this divergence—based in broad economic trends or simple industrial comparisons—are unappealing. In this edition of Global Perspective, we use accounting reports to find that this difference is due to a pronounced restructuring of balance sheets by US firms looking to take advantage of the new, post-financial crisis environment, while European firms fall behind.

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Identifying the sources of European equity market weakness

European equities have struggled to find their footing, particularly compared with robust US gains. We identify an overlooked explanation for this trend: a rising number of US-listed firms are much more capital disciplined than their Eurozone counterparts.

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What explains Europe's disappointing returns?

In 2014, European equity markets struggled against a disappointing economic and policy backdrop, with performance flagging sharply against their US peers. Not surprisingly, geopolitical conflicts on Europe's doorstep and deteriorating growth prospects among trading partners, especially in Latin America and China, badly hurt confidence in the corporate sector. The earnings season underwhelmed, and European policymakers moved only fitfully toward providing effective monetary stimulus. Accordingly, European equities fell well behind their US peers during the year (see Chart 1), opening—by some measures—the deepest discount in almost two decades.

A deeper analysis should resist the temptation of using temporary business cycle outturns to explain away Europe's equity market woes. While the cyclical headwinds are undoubtedly strong, fundamental investors need to ask whether Europe is cheap—or cheap for a reason. Part of the economic adjustment and disinflation in Europe reflects long-delayed and much-needed structural adjustments to improve overall competitiveness of corporates, an unalloyed positive development.

Rather than the business cycle, we see valuations as benefiting from a post-crisis, significant leap in the capital efficiency of a small number of US firms. Specifically, since 2009, there have been a growing number of companies with truly exceptional return on equity (RoE). This trend transcends industries—so it is not just a story of improved sectoral competitiveness and the relative mix of firms between the two different markets. In particular, large US multinationals—especially branded goods firms—have been more nimble in responding to a low interest rate environment, by making active use of share buybacks, increasing leverage, or managing their revenue streams and working capital better. As the best US performers are also larger and more global, their earnings have benefited from the decade-long trend depreciation in the US dollar. Furthermore, excluding these 'return champions', the aggregate RoE of these businesses has not changed substantially over the past 15 years.

Central to this finding is a realisation that, in a period of low yields, investors are willing to pay an exceptional premium to access those assets that offer the optionality of truly outstanding returns with predictable cash flows. Thus, US equity valuations are bid higher as investors seek the chance of higher earnings, even if those expectations are not eventually realised. This highlights the importance of examining trends in the tails of the distribution, where investors may be seeking ways to outperform the market.

Greater similarities than differences between European and US firms

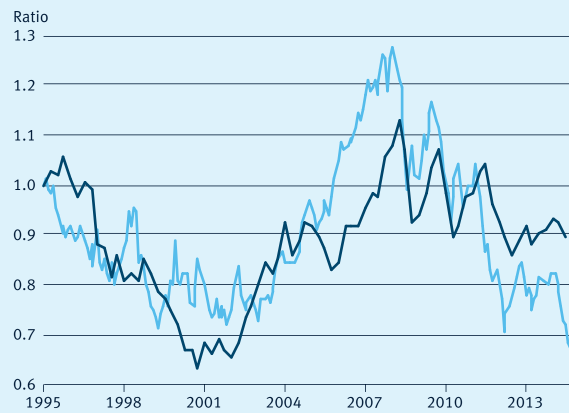
The most common explanation for weak European equity returns is the poor performance of corporate earnings in a weak economic environment. With the onset of the sovereign debt crisis in Europe, profits struggled, moving sideways in euro terms for four years (see Chart 2). By contrast, US performance has been superlative. Using this straightforward explanation, the investment case seems simple: investors should wait until European conditions improve.

However, this apparently clear-cut explanation glosses over the improvements of many European firms in becoming more disciplined on labour utilization (see Chart 3), progress that should be reflected in stock prices. The ongoing recession has forced meaningful operational restructuring, and unit labour costs are finally drifting down in Europe. Much of the recent adjustment has, indeed, come from peripheral economies such as Portugal and Spain—where unemployment has surged and many low-value added firms that thrived during the bubble years have now been forced to exit. However, wage pressures are also flagging in the core countries as well, with a noticeable down-trend in unit labour costs since early 2013. This is in contrast to the US, where unemployment rates have already drifted to levels consistent with wage pressures that should start feeding into general prices and margins.

Because European firms are not being recognised for their efforts, we conducted a deeper analysis using detailed company level data to identify the links between operational efficiency and RoE. We use RoE in this analysis because it is available on a consistent basis across countries and firms and reflects the ability of a firm to generate net income for its equity investors. In principal, firms with exceptionally high RoEs should induce entry into that sector, as competitors seek to copy and improve on that business model, so this serves as our primary valuation metric.[1] Accordingly, we explained returns as being driven by a combination of firm-specific

[1]However, there are other measures of valuation (including by looking at the ratio of earnings to enterprise value). We plan a more robust test of this model in a forthcoming Global Horizons publication later in 2015.

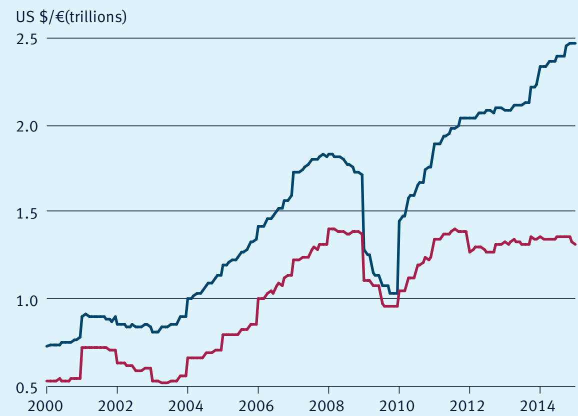
Chart 1
Mind the gap



Rebased as of Q1 1995, in US dollars:
MSCI Europe ex UK index performance relative to MSCI USA Index
Eurozone real GDP relative to US GDP

Source: Eurostat, BEA, Datastream (as of 31 December 2014)

Chart 2
Anemic Eurozone earnings



Total EBITDA of Datastream market indices: US Europe ex. UK

Source: Datastream (as of January 2015)

characteristics and the overall economic environment.[2] To capture idiosyncratic differences in the firms' business models, we looked at measures of turnover, geographical dispersion of sales, and industrial sector composition to pick up whether firms are in the right industry, selling to the right customer, or are efficient in managing their sales. However, resourceful balance sheet management could convey an important competitive advantage, so we also looked at lagged return on assets (as a measure of capital discipline), leverage, and firm size. Global and regional effects were captured in a time dummy (reflecting the business cycle) and an indicator of whether firms were US listed.

There are, however, important limits in using a consistent data set across a wide variety of firms (e.g., financials versus non-financials), markets (US versus Europe), and time (over the past 15 years). Importantly, we took RoE as the simple ratio of earnings to common equity, which leads to two potential problems. First, this measure of RoE tilts the results towards those firms that have restructured quickly (wiping out the value of common equity in one year, before new shares are reissued). That said, our analysis does attempt to filter out the few firms that went through restructuring, to mitigate part of this concern. Second, firms that are capital-light may have exceptional RoEs—although this may be reflective of sectoral differences that would be partly captured in the industry dummy variable in our analysis. Because of these caveats, it is important to focus on any changes in the patterns of returns or their drivers, rather than the absolute level of RoE.

Our analysis matches the aggregate data well, but—somewhat surprisingly—only for firms with an RoE between -27% and 76%, or around 95% of the equity market (by market capitalisation). This range of firms is an exceptionally broad swathe of the 'fundamentally normal' market. The model's success gives some confidence that we have identified the more important drivers of returns (see Table 1). Importantly, using only the 'fundamentally normal' firms, there are not systematic errors in the estimated results between European and US markets.

By contrast, it is not possible to reflect accurately the drivers of returns on equity using the entire data set, as including the extremes leads to very poor results (Table 1, "Full sample" line items). For US firms, the problem is extreme. From 2001 to 2007, US RoEs are overestimated by a factor of three. But then, starting in 2008, our simple model would suggest negative and falling returns for US firms (of 8-10%), in contrast to the actual experience of high and rising returns (of 18-21%). For European firms, the fit from 2008 onward is also poor, overestimating returns substantially.

To some extent, it is not surprising that a single model fails to capture such widely disparate profit outcomes. At the left hand tail, these firms are generally failing and near bankruptcy, driven there by extremely poor management or by an unfavourable economic environment. At the right hand tail, high return firms are likely managing their operations and balance sheets in an exceptional manner. In any event, the outsized influence of the tails of the distribution serves as both a caution to those doing analysis on the aggregates and a guide to further analysis.

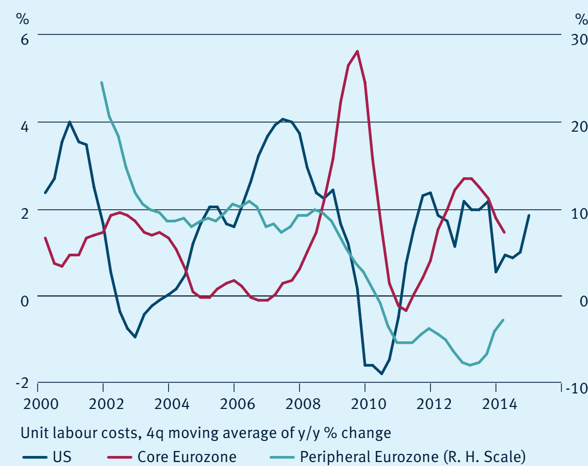
Because the extremes cause such problems in describing returns, our analysis accordingly concentrated on the set of 'fundamentally normal' firms. We found firm-specific attributes are not the primary driver of differences between the US and Europe (see Chart 4).[3] Furthermore, these micro-level factors are, in aggregate, essentially constant over time (the totals are the black dots on Chart 4). While this is partly attributable to the time dummy included in the model, large cyclical swings did not pose an exceptional problem to the fundamental business model of most listed firms.

In particular, European and US firms generate returns very differently. European firms are not as efficient at maintaining capital disciple, with a lower return on assets and fewer sales through turnover. Also, Europe has fewer publicly traded firms within high-margin industries (such as technology—representing about 15% of the US market, versus only around 5% in Europe)—although in practice, this sectoral difference represents only a modest headwind to RoEs. By contrast,

[2]These detailed data permits a joint analysis of the impact of overall economic conditions and industry and firm-specific drivers of returns. Detailed data help in another regard; we have a relatively limited time span of data (generally only starting in 2000) for most firms, and we are also interested in developments in the aftermath of the financial crisis. Such short time periods makes it impossible to use only aggregated data on the corporate sector, as there is not enough information to derive meaningful results or uncover emerging trends.

[3]Technically, the model results displayed here reflect the estimates from a non-linear truncated distribution regression model with censoring limits (of -27 and 76) chosen by the Akaike Information Criteria.

Chart 3
Eurozone efficiency improving



Source: Datastream (as of Q3 2014)

Table 1
Impact of using full data set on explaining RoEs

% return on equity; averages are unweighted by market capitalisation

	Pre-GFC 2001 - 2007		GFC 2008-2009		Post-GFC 2010 - 2013	
	Estimated	Actual	Estimated	Actual	Estimated	Actual
Europe, using;						
“Normal” firms*	15.5	15.5	17.7	18.1	14.8	14.6
% of market	*98*		*99*		*95*	
Full sample	115.2	122.1	49.5	19.2	49.9	15.2
United States						
“Normal” firms*	16.3	16.3	19.4	18.6	16.7	17.0
% of market	*97*		*98*		*95*	
Full sample	47.1	16.3	-8.2	17.8	-10.3	21.0

* Those firms with a RoE (Return on Equity) between -27% and 76% inclusive

Source: Standard Life Investments (as of 2013)

European firms often face a more favourable set of market conditions, operating in more regulated markets that helps them to secure higher profits. Meanwhile, US firms tend to operate in highly competitive regions (such as North America itself), driving down earnings.

Over the past decade, economic conditions appear to be playing a more significant role in driving returns for both markets (see Chart 5), suggesting that macroeconomic forces cannot explain the gap between US and European firms. Starting in the early 2000s, macro drivers accounted for just over one-third of average RoE. This slowly changed as the business cycle matured and by the eve of the financial crisis, the business cycle dominated. Post-crisis, the economy retreated only marginally in importance, as global trends are still playing an elevated, and more significant, role. However, US and European businesses have been affected equally; indeed, throughout this period there has been only a small return premium (around 1½ percentage points of the overall RoE) for firms being listed in the US.[4]

Rise of the return champions

The results in the previous section now pose a substantial puzzle. For most firms, there is remarkably little dis-similarity in aggregate returns. Additionally, any differences that exist are largely constant over time. The only factor that varies significantly is a measure of the global (and not national) business cycle. So what accounts for the yawning gap in performance between the two equity markets?

The answer to this question appears to lie in the tiny sliver of firms discarded while attempting to fit a good model of returns.

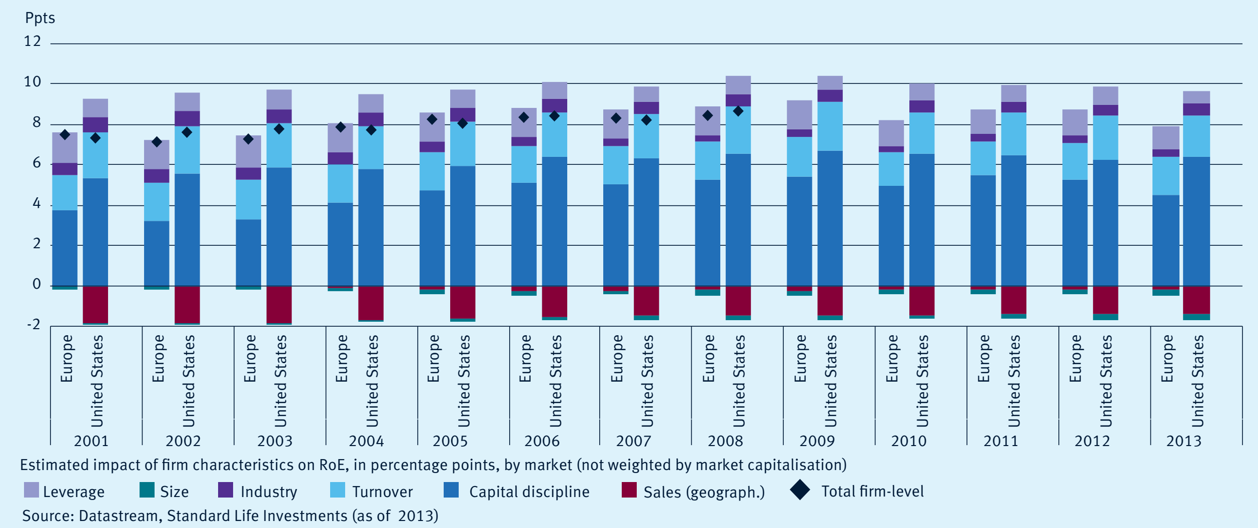
There has been a structural change, post-financial crisis, in the number of US firms that have generated outsized yields, with no such trend in Europe (see Chart 6). In the decade leading up to the financial crisis, there were, on average, five firms a year with a super-sized RoE, each one averaging 160-170% in this period in both markets. However, they were also an insignificant share of the overall market, representing no more than 1% of market capitalisation in total. Post-financial crisis, even fewer European firms were able to eke out excess profits, no more than five a year in 2010 and falling to only two by 2014. By contrast, in the US, there was more than a doubling in the number of firms (to about 13 on average per year), accounting for around 4% of the market. As the absolute level of RoEs are less important than the changes, it is remarkable that the average RoE of these US ‘return champions’ also doubled, to just over 330%. Such surges seem to suggest that US firms have been substantially more active than European firms in restructuring.

Some of this structural change in returns is due to the rising prevalence of share buybacks in the US (see Table 2). Mechanistically, if firms use cash on their balance sheet to repurchase equities in the market, this can boost RoE. Whether or not this is the best use of cash, clearly a large number of US firms are finding it more attractive to acquire their shares than invest or retire debt. ‘Return champions’ are about 30% more likely to participate in share buybacks than lower RoE firms. However, the relatively small size of the overall repurchase programmes—only about 5% of the overall market—make it unlikely that this is the sole explanation.

More importantly, high return US firms have a markedly different business model than others in the market (see Table 3). Importantly, these firms are big—1.7 times more likely to be in the top quartile of sales—and in the consumer staples sector. They are also internationally focused, as return champions are about 30% more likely to generate sales from abroad than more normal firms. Additionally, these firms are nearly eight times more levered, perhaps reflecting better access to capital because of their size and international scope. We also see a modestly higher return on assets—our proxy for capital discipline. These trends suggest that the balance sheets of firms in this group are more actively managed than more normal firms with lower RoEs. Finally, it is notable that there are no conglomerates, basic materials or energy companies, financials, or utilities in the group of return champions; these industries are either too competitive or too regulated to generate excess returns.

[4] This is not entirely inconsistent with academic studies that show a benefit to the stock prices of US-listed firms. For example, these firms may respond over time by issuing more equity, which would drive down the RoE of the firm. Similarly, these studies also often focus on a narrow segment of the market, which may obscure broader trends.

Chart 4
Differences are not down to firm-level specifics



Estimated impact of firm characteristics on RoE, in percentage points, by market (not weighted by market capitalisation)

Source: Datastream, Standard Life Investments (as of 2013)

Because there are only a few European firms who qualify as a 'return champion', there are likely fewer lessons to be learned, but two salient points emerge. First, high European RoE firms are much more likely to be in the consumer staples industry, similar to their US brethren. Second, European firms are over twice as likely to be small (in the bottom quintile of sales). Thus, these firms may be in the uninvestible part of the market, as trading liquidity is too light for most global investors.

Summary

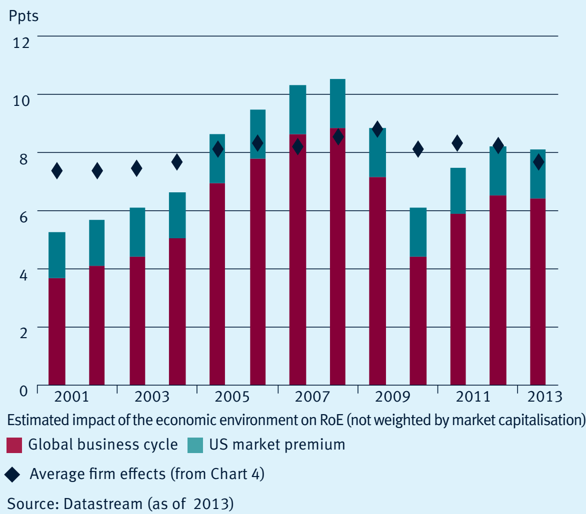
Taken together, we find that US firms are often better at deploying their balance sheets and taking advantage of globally low interest rates. While not examined here, large firms can issue debt more readily, so the higher leverage ratios are suggestive of possibly higher bond issuance of return champions. By contrast, European firms have not managed their assets and liabilities as aggressively, perhaps because of the business challenges from maintaining operations amid the sovereign debt crisis in the region. Also, European banks have been limited in their ability to extend credit, which—along with the relatively shallower capital markets on the Continent—could also limit the ability of firms to deploy capital efficiently.

Indeed, it is not surprising that equity investors would be willing to pay a premium to gain exposure to the US market, as there is considerable turnover between those firms that are return champions and the broader market, thereby leading to possible spillovers. During the post-crisis period, there have only been three firms who have been a 'return champion' for the whole time. As a result of churn, the practices of the return champions might be becoming more widespread, leading to higher returns from more shareholder-friendly firms. In this light, the US share premium is not as much a mystery, as it also reflects access to more nimble and capital-light firms. This prospect is especially important in the context of a low return, low growth environment.

What could turn these trends around? While continuing research into this topic, there are several trends that bear close observation. First, if US firms find it difficult to refinance debt or otherwise transform their capital structure, this could quickly undermine the premium that US firms enjoy. One key test will be to observe how firms react to plans by the Federal Reserve to normalise monetary policy and lift interest rates. Second, given the broad international reach of US return champions, a stronger US dollar may pose exceptional challenges to these firms, as the appreciation of the exchange rate reduces the US dollar value of profits booked abroad.

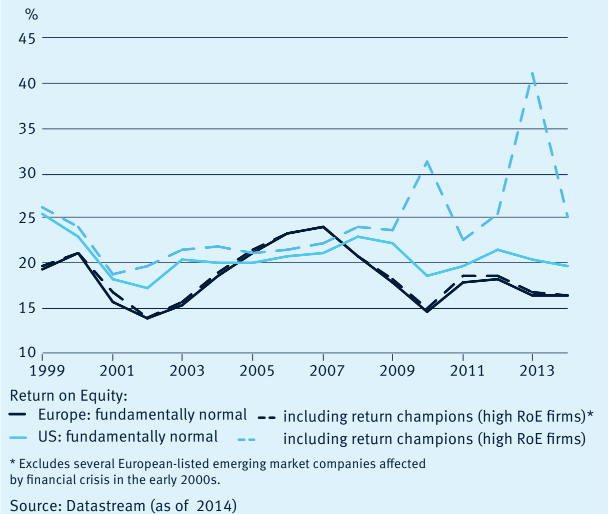
From the European perspective, firms may finally have an opportunity to narrow the return gap with their trans-Atlantic competitors, but only if they take advantage of an improved financial environment. European policymakers are moving more conclusively to address longer-term structural and financial sector blockages, which should help the banking sector support balance sheet restructuring. If larger, more investible European firms become more disciplined in managing their balance sheets, investors could readily take note and reward such shareholder-friendly moves. The euro's recent depreciation may also convey competitive advantages, both through mercantilist channels and because European firms would generate a boost to foreign earnings from a weaker euro. While some of these trends are beginning to be reversed, this valuation gap has emerged over the previous five years and thus is only partly priced into the markets.

Chart 5
Macro in the driving seat



Source: Datastream (as of 2013)

Chart 6
Rise of the return champions



* Excludes several European-listed emerging market companies affected by financial crisis in the early 2000s.

Source: Datastream (as of 2014)

Table 2
Importance of share buybacks

	Pre-GFC	Pre-GFC	Post-GFC
Europe	3	119	28
Return champions*	0	0	7
United States	28	239	452
Return champions*	0	5	23

Share buybacks, local currency (billions)
*Those firms with a RoE above 76 percent.

Source: Bloomberg, Standard Life Investments (as of 2014)

Table 3
Relative frequency of return champions

	US	Europe
Capital discipline*	1.6	2.7
Leverage†	7.7	0.6
Turnover#	1.2	2.0
Large firms (by sales)	1.7	0.5
Small firms (by sales)	0.4	2.1
Foreign sales	1.3	1.1
Industrial composition:		
Basic materials	0.0	0.0
Communications	0.4	0.2
Conglomerates	0.0	0.0
Consumer cyclicals	0.9	1.0
Consumer staples	4.4	3.9
Energy firms	0.0	0.0
Financials	0.0	0.0
Industrials	1.7	0.3
Tech firms	1.7	9.1
Utilities	0.0	0.0

Relative to fundamentally normal firms (2010-14)
*Lagged ratio of return on assets. † Lagged ratio of assets to common equity. # Ratio of sales to assets

Source: Standard Life Investments (as of 2014)

House View

The following asset allocation is based upon a global investor with access to all the major asset classes. For regional versions of the House View, please contact your Standard Life Investments representative.

	February 2015 House View	
Risk	The Global Investment Group emphasises moderate levels of risk, focusing on assets either with sustainable yield or those able to provide sustainable earnings expansion in a moderate growth environment.	NEUTRAL
Government Bonds		
US Treasuries	The end of QE and the economy's strength should enable the Federal Reserve to start raising interest rates in mid-2015, although it will use forward guidance to control the pace of yield movements.	MOVED TO VERY LIGHT
European Bonds	Bonds are supported by an environment of low inflation and modest economic growth. ECB QE can cause peripheral spreads to tighten further, but the Greece situation requires monitoring.	HEAVY
UK Gilts	The asset class is vulnerable to interest rate increases as economic growth remains firm while valuations are expensive. Manageable inflation pressures and central bank guidance can anchor rising bond yields.	LIGHT
Japanese Bonds	The long-term inflation outlook is deteriorating as the government aims for reflation, although the Bank of Japan's sizeable bond-buying programme should prevent yields rising significantly.	LIGHT
Global Inflation-Linked Debt	Inflationary conditions are subdued in many developed economies, although valuations in individual countries require careful examination. Investor worries remain about future inflation due to easy monetary policies.	NEUTRAL
Global Emerging Market Debt	Dollar-denominated bonds are Heavy, as spreads show better value, while local currency bonds are Neutral as careful examination is required of individual currency and spread factors.	HEAVY/NEUTRAL
Corporate Bonds		
Investment Grade	Attractions such as positive corporate cash flows are increasingly priced in, while upward pressures from government bond markets will periodically affect total returns.	NEUTRAL
High-Yield Debt	Spreads have widened, creating a more supportive valuations environment, especially for US bonds over European debt. The bond default outlook is favourable but market liquidity remains a concern.	NEUTRAL
Equities		
US Equities	Economic growth and investor sentiment are supportive, but valuations are expensive and profits margins are likely to compress due to higher wages as well as the impact of a stronger dollar on overseas earnings.	MOVED TO NEUTRAL
European Equities	Valuations are supportive and corporate competitiveness improving, while earnings look to benefit from further depreciation of the euro as well as the impact of lower energy costs on consumers and many businesses.	HEAVY
Japanese Equities	Many structural reforms remain outstanding but growing management focus on return on equity and plans to cut corporation tax are supportive. Meanwhile, the Bank of Japan is taking action to reach the inflation target.	HEAVY
UK Equities	Economic data is a positive driver, but profits margins are coming under pressure from a mixture of currency strength and commodity price weakness. Meanwhile, political uncertainty could become an issue later this year.	MOVED TO NEUTRAL
Developed Asian Equities	Slowing commodity demand, particularly from China, is affecting some countries such as Australia. The lower oil price is leading to noticeable winners and losers among exporters and consumers.	LIGHT
Emerging Market Equities	Commodity export dependent markets have deteriorated while those with strong domestic fundamentals are improving. Politics, current account positions and central bank actions are other drivers of divergence.	NEUTRAL
Real Estate		
UK	The robust growth environment continues to bolster prices in the near term, and yields remain attractive compared to other assets, suggesting reasonable returns over a three-year holding period.	HEAVY
Europe	Prime assets in core markets offer attractive relative value given QE and the low interest rate environment, while parts of the periphery are starting to show consistent value growth.	NEUTRAL
North America	Canadian property faces headwinds from an interest rate-sensitive consumer and significant office construction. The US should benefit from continued economic growth but pricing is quite aggressive.	NEUTRAL
Asia Pacific	Yields are broadly stable, while the attractive yield margin and recovering rents are driving pricing. Japan remains ahead in the property cycle, followed by Australia.	NEUTRAL
Other Assets		
Foreign Exchange	The US dollar will benefit from eventual monetary policy tightening. ECB and BoJ actions have weakened their respective currencies, while the pound will be held down by political uncertainty.	MOVED TO HEAVY $, NEUTRAL £ , MOVED TO NEUTRAL € & ¥
Global Commodities	Different drivers, such as US dollar appreciation, Chinese demand, Middle East tensions and climatic conditions, influence the outlook for different commodities. Supply issues and OPEC inaction will keep prices constrained in 2015.	NEUTRAL
Cash		
	Unconventional monetary policy is ending in the US and UK; some emerging markets are also tightening. QE in Europe and Japan will keep their interest rates low.	MOVED TO NEUTRAL

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