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RBC WEALTH MANAGEMENT

Global Insight

Focus Article

Continental shift: The appeal of European equities

After emerging from a long stretch in the doldrums, the shine is back for European stocks.

Dominic Wallington

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All values in U.S. dollars and priced as of June 30, 2017, market close, unless otherwise noted.

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Focus article

Continental shift: The appeal of European equities

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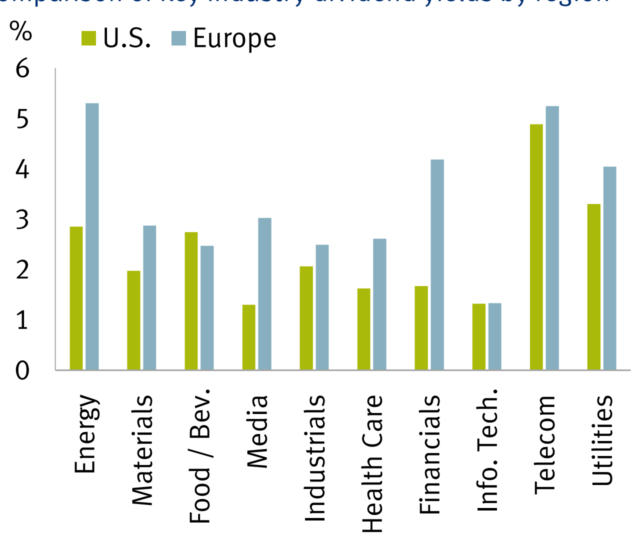
To us, the prospects for European equities look brighter than they have for quite some time. We recently upgraded the region, citing reduced political risks, improved economic and earnings growth, and attractive valuations.

To gain additional insight we recently spoke with Dominic Wallington, head of European equity at RBC Global Asset Management. He discusses why equities in the region are appealing from his vantage point as a fund manager. He goes on to offer insights into the unique characteristics of European companies, including their long-standing dividend-paying tradition, centuries-old business franchises, and high-return traits.

Q. Are there distinguishing features of European companies that are particularly attractive for long-term investors?

A. One of Europe's most attractive features is its long history of sharing profits with shareholders in the form of dividends. This stems at least back to the year 1600 when Queen Elizabeth I gave a royal charter to the East India Company for which the *quid pro quo* was that the company would pay a dividend. So this is a very long-lived cultural phenomenon at which Europe tends to excel.

Comparison of key industry dividend yields by region



The dividend-paying tradition remains to this day.

Note: For U.S., S&P 500; for Europe, Dow Jones Europe and STOXX Europe; data as of 6/26/17
Source - RBC Wealth Management, Bloomberg

Q. Many companies in the U.S. and in other global markets also pay dividends—what makes the European dividend-paying companies unique?

A. Europe has some of the oldest companies in the world. These sorts of companies have seen their returns persist for very long periods of time, sometimes centuries, not only in the form of profitability but also in terms of the franchise itself. A surprising number continue to dominate their particular sector or industry segment not only in Europe but globally.

LVMH is an example—Louis Vuitton opened its doors in the middle of the 19th century, but is also the owner of many brands that go back much further. One of these, Chaumet, has been around since 1780, making jewelry for the French aristocracy. The historians amongst you will know that business was curtailed in 1789 by the French Revolution. But by 1802, Chaumet had become the official jeweler to Napoléon I. Today the company has more than 80 stand-alone boutiques around the world and is in hundreds of other retail locations.

The reason I relate company histories is to point out these are long-lived franchises, with great cachet, that have existed during repeated periods of political and economic upheaval. They tend to possess the characteristics we focus on—high internal rates of return, low capital intensity, stability, international reach, and the proven capability to weather all sorts of storms.

Example of European global leaders with a long history

Many European companies have lived through tumultuous times

Date of origin		
1854	LVMH	Luxury brand – LVMH (Christian Dior)
1925	novo nordisk	Diabetes care company – Novo Nordisk
1880	Reed Elsevier	Scientific publisher – RELX
1885	Unilever	Emerging market FMCG company – Unilever
1849	essilor	Corrective lens supplier – Essilor
1896	Roche	Supplier of cancer medicines – Roche
1925	novozymes	Supplier of enzymes – Novozymes
1874	CHR HANSEN	Supplier of food cultures – Christian Hansen

Source - RBC Global Asset Management, RBC Wealth Management

Q. You say "high-return businesses" should be a priority for investors of European equities. Why is this important to you as a fund manager?

A. For the simple reason that in the normal course of events, if you attach yourself to a company that earns a high return, it is likely that you as an investor will also garner a high return. Broadly speaking, we're referring to companies that deliver a high return on equity, or said another way, companies that generate a high level of profits as a proportion of the money shareholders have invested.

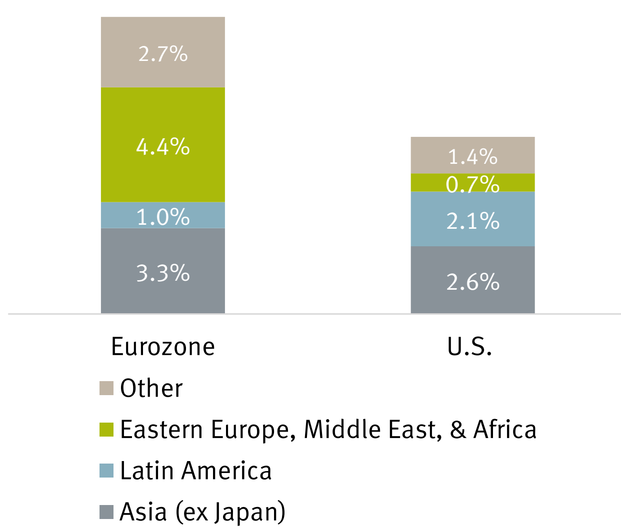
When we look at two different companies—one with a return on equity of 15% and one of 5%, and apply the same balance sheet to both and reinvest all the proceeds, then the 15% return business is worth more from a shareholders' equity perspective over a 10-year period than the lower return business by a factor of nearly five times. So we tend look for these high-quality corporate franchises. We believe companies that have the widest, deepest moats (i.e., barriers to entry) and the highest returns on equity will deliver the best returns to shareholders. Moreover, among high-return businesses, there are still a number of European companies that trade at a discount to their U.S. peers.

Q. What specifically is it about European companies' international exposure that is so appealing at this stage?

A. Europe engages in a great deal of international trade. With the U.S., China, and Europe all growing, the world is enjoying a period of synchronized global growth. This benefits many European companies which tend to generate an above-average proportion of revenues and earnings outside their home markets.

Within this international profile, the region also has significant exposure to emerging market (EM) economies, which are usually thought to be outsized beneficiaries of synchronized global growth. At the same time, European companies have strong corporate governance and strict accounting rules. In effect, shareholders can access EM exposure through European equities with less corporate risk than most companies headquartered in those markets.

Gross exports to emerging markets as a percentage of gross domestic product



The eurozone's exposure to emerging markets is twice that of the U.S.

Source - National research correspondent, RBC Wealth Management

Q. What are some of the key investment themes that you run across in Europe?

A. We're not thematic investors but when we did a deep dive into the franchises that had exhibited great returns over long periods of time, we began to realize there were other things going on in terms of persistent thematic trends.

Industry concentration is one area, as there has been a general move away from the strict application of antitrust rules in many developed markets and parts of Asia as well. This benefits large, dominant European businesses. We've seen very substantial mergers and acquisitions, which I think is a continuation of this theme. For some industries, what it confers is huge corporate power and simultaneously a dramatic reduction of competition. As an investor, one has to celebrate this trend because it means the moats (barriers to entry) are remarkably deep and wide, and the levels of profitability are considerable.

Industry concentration, digitization, chronic illness, and food technology are themes we think will be long-lived and benefit European companies.

Another theme is digitization, not only on the internet, but also more broadly how digitization and machine intelligence improve returns of businesses. Artificial intelligence promises to be the next, powerful manifestation of this theme.

Within health care, chronic illness is another powerful theme for us. We look at companies that deal with things like the treatment of diabetes, the first non-communicable global disease pandemic which affects 371 million people globally. Another example would be short (near) sightedness, as it has doubled in a generation partly because of the increased use of LED screens and aggressive education systems in many developed markets.

Food technology is another theme we follow. Food products are moving into emerging, fast growing markets that they couldn't have previously due to advancements in fermentation, enzymes, and isolates. For example, one company we follow has developed a culture for yogurts that removes the need for refrigeration. This enables the company to sell its products in China where tastes favour room temperature yogurt.

We think these themes will be long-lived—over decades—and should benefit European companies, especially those with deep moats.

Q. Notwithstanding their long-term appeal, is this the right time to be considering European equities?

A. European stocks have usually traded at a price-to-earnings multiple discount to U.S. equities. Brexit and the rise of populist, anti-EU parties in several countries widened that discount out to unprecedented levels over the past year. Recently, the French election of a centrist, pro-EU government appears to have marked an easing in those tensions. We believe European equities, particularly the kind of all-weather, persistently high-return dividend payers we have been talking about here, can be acquired today at valuations which are at a discount to those of U.S. peers, at a time when revenues, earnings, and profit estimates all appear to be on the rise.

Research resources

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