

Making the Case for European Style

It has been well understood for some time now that Style offers a very robust method for analysis within the US equity market. It offers fair and accurate criteria for describing managers and assessing their performance; it provides a mechanism for classifying market securities and for researching the structure of market performance; and it is useful in analysing portfolio performance.

What is not yet appreciated, however, is how much Style can offer within the major non-US markets, and particularly within the major markets in Europe.

The reasons for this “oversight” appear to be two-fold:

Firstly, unlike in the US, where a simplified approach to Style has evolved from several decades of Style practice, most European practitioners believe that the approach to Style in European and other non-US markets can not be so easily simplified. It is widely held that international Style models must be sensitive to particular local analysis cultures and the particular performance characteristics of each market, individually - and this takes a great deal of time and effort.

Secondly, and very unfortunately, there seems also to be a developing scepticism surrounding the Style concept owing to the attempt by some overly enthusiastic “one-size-fits-all” analysts to popularize Style using a hasty application of only the most rudimentary criteria uniformly across the diversity of the European Continent.

Research at Style Investment Research Associates works to meet each of these concerns by exploring more deeply into the bedrock of Style within the major markets. Our analysis employs a comprehensive set of key securities criteria in the development of Style models within international markets. The work shows that Style, properly applied, offers very significant rewards to stock analysts and portfolio managers in European and other non-US markets.

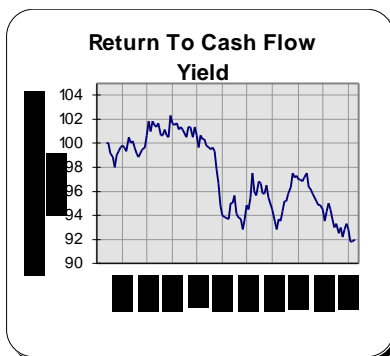
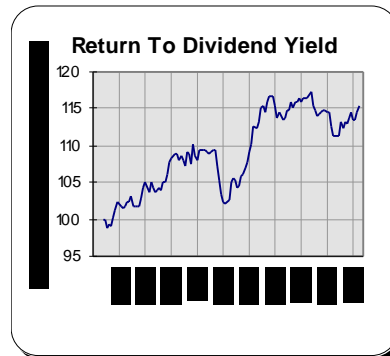
Style Investment Research analysis covers a number of key issues in the Style debate:

- 1 Styles must be describable across a broader range of criteria than simply Book to Price (and Dividend Yield) for Value and Growth, and Size. In different markets, differing reporting requirements, accounting standards, fiscal structures, investor preferences, and differing savings industry configurations all warn very clearly that we ought to be prepared that different Style criteria will be relevant in different markets. Yet we must avoid obscuring the issue with complex analysis.

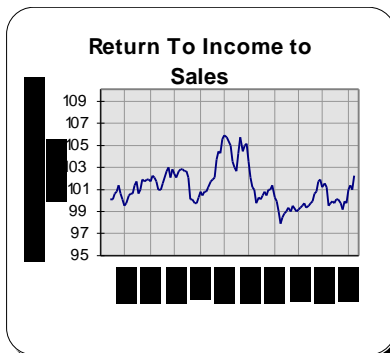
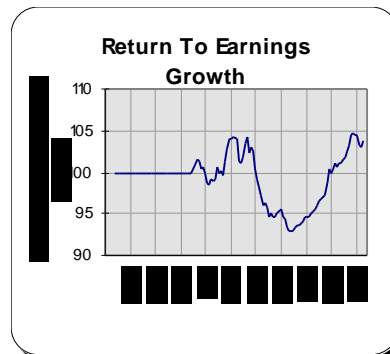
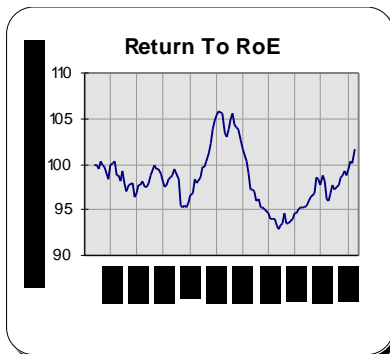
To be able to detect various local market Style determinants, Style Investment Research reviews a total of 14 basic, and accessible, factors in each market. We focus on 5 Value criteria, 4 separate Growth criteria, 2 Size/Risk measures, a returns momentum measure and 2 other criteria. And in each case the factors reviewed are traditional Balance Sheet entries, P&L items, or basic market information. Using these primary fundamental criteria we systematically evaluate the active Style return patterns operating within 16 major and a further 12 minor tradable equity markets. The results are very convincing, and very practical.

Data from the UK are instructive.

UK Value Criteria



UK Growth Criteria



The evidence speaks clearly. Value stocks, defined according to Book to Price, Dividends, Cash Flow or Sales have tended to perform to a similar profile, and Growth stocks, also defined according to a number of separate criteria have also performed similarly. And Value and Growth stocks have tended to mirror (in reverse) each others performance over a reasonably long period. Furthermore, the return cycles are in most cases quite regular, displaying significant trending and cyclicity, and offering potential for further research. Traditional measures of Value (B/P and Dividends) may no longer offer the secure long term investment strategy they have been thought to provide. Cycles in Traditional Value can sustain medium term downturns; and Earnings flows and Growth factors ought to be seriously taken into account in medium term portfolio planning!

- 2 Our research also disentangles Style from industry cycle effects. This analysis distinguishes tradable patterns in both industrial sector trends as well as within the key Style cycles. Although concerns have been raised that Value and Growth Cycles might be no more than masquerading industry cycles or interest rate cycles, our evidence points to the contrary and highlights the independent significance of pure Style effects. The research demonstrates that in most cases the return profiles of the “sector adjusted” Style factors closely resemble the profiles of the standard factors, indicating that the Style influences stand independently from industrial cycle effects. And on the occasions that they do differ markedly, we can generally extract some very useable market understanding.

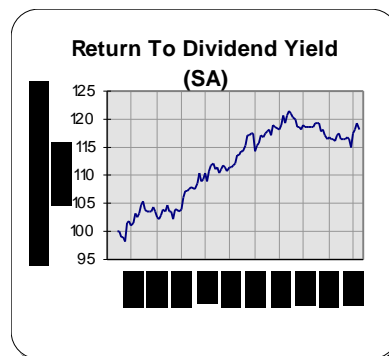
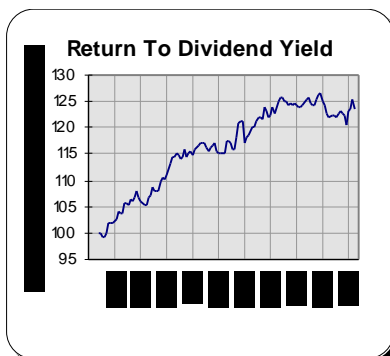
The following data from France, Germany and Switzerland are quite typical:

French Value Criteria

Standard Analysis



Sector Adjusted Analysis



Whether considered simply across the market, or sector adjusted (measuring criteria relative to sector averages), French Value cycles are consistent. While Book to Price used not to be a particularly helpful theme in the past, it has recently been a key feature behind the decline in Value related issues. This pattern of performance is also reflected in the profile of the return to Dividend Yield, another very popular Value criteria. Furthermore, as in the UK, the cycles trend noticeably and offer the potential for further productive research.

As in much of Europe, Value investing has done particularly badly of late. Value securities used to perform pro-cyclically with the economy, but the recent cycle has been different. Unless we believe interest rates will rise dramatically (favouring current yield over future flows) it is probably sensible to attach some

scepticism to the current apparent upturn and still to retain exposure to some particular Growth features, even within committed Value portfolios.

German and Swiss Momentum Investing

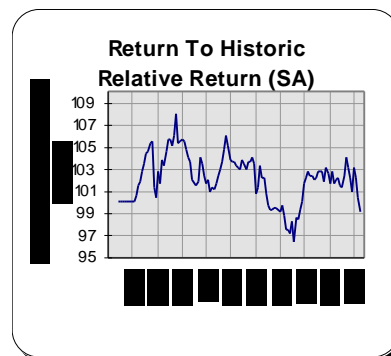
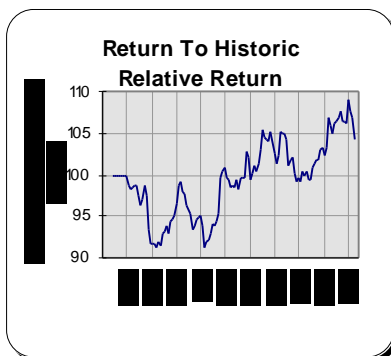
Standard Analysis

Sector Adjusted Analysis

Germany



Switzerland



From the left hand charts, it appears that investing in stocks which have recently gone up, relative to the markets, ought to be a reasonable medium term strategy.

The right hand charts, however, indicates that investing in stocks which have recently risen relative to their sectors has been a very poor strategy. The information drawn from these two features is that in both German and Switzerland, it is the major industrial sectors that appear to trend significantly, not the individual securities. Contrary to the indications of the simplified

technical analysis, we should not be enticed simply to back individual security winners.

- 3 The Style cycles across markets are, in most cases, not synchronized. This applies not only across unrelated markets, but also across markets of supposedly closely connected economies (e.g. Europe!). In addition, multi-market analysis is further complicated by the recognition that relevant criteria will differ across markets, even for the most standard Style characteristics. Nonetheless, we can make progress in regional Style analysis using a bit of common sense.

By reviewing markets in turn, looking at consistent comprehensive criteria, but in different ways and with different emphasis, and complementing the data with intelligent interpretation, we can get a long way.

Although the general pattern of regional and multi-market Style returns is usually obscured when a regimented, one-size-fits-all analysis (always using the same restricted criteria uniformly across markets) is attempted, the more sensitive analysis is very often more revealing. The excerpt below, taken from the Summary page in our Global Style Advisor review, demonstrates this in the current market environment.

Style Return Patterns in the Major Markets and Regions

	VALUE (Standard) (SA, if different)		GROWTH (Standard) (SA, if different)		SMALL (Standard) (SA, if different)	
<u>North America</u>						
USA	-		+		-	
Canada	+		0	+	-	
<u>Europe</u>						
UK	0	-	+		-	
Belgium	(↗)	0	(↘)		-	
France	(↗)		(↘)		-	
Germany	+		0	(↗)	(↗)	
Italy	(↗)	+	+	0	-	
Netherlands	+		-	0	-	
Spain	+		0	+	-	
Switzerland	-	(↗)	(↘)	0	-	+
Denmark	-		-		-	
Sweden	(↗)		0		0	-
<u>S. E. Asia</u>						
Japan	0		+		-	
Australia	+		(↗)	0	+	
Hong Kong	0		0		-	
Singapore	+	-	0	-	(↗)	

Notes: Standard - Analysis not adjusted for industrial sector influence.
 SA - Analysis adjusted for industrial sector influence.
 +/- - Predominantly positive / negative returns from the principal criteria for that Style.
 0 - Either no discernible trend or the principal criteria for that Style are in conflict.
 ↘ ↗ - Indications that the Style return pattern is turning negative, turning positive.

Even though we may be looking at slightly different criteria within many of the individual markets, standing back far enough the picture becomes clearer. Value investing looks poised to attempt a long awaited but uncertain recovery across Continental Europe. Growth is still the dominant theme in the US and UK. Japan has recently broken its long term Value bias and Growth is rebounding sharply. And with only a few exceptions, small and lower mid-cap investment strategies are faring relatively poorly

It is quite clear. Style is important, and exploitable, across the majority of international equity markets. Styles can be described simply according to familiar investment

criteria used by traditional investment managers in day-to-day securities analysis; but we must not be too rigid. Sometimes criteria differ market to market, and the influences of key Style criteria do change through time. But this is only what we would expect from traditional securities analysis.

Style is a practical, intelligible approach to global equity analysis, stock selection and portfolio review. It offers a genuine link between the efforts of quantitative analysts and the practical needs of active managers, and can add significant value. No doubt much work lies ahead, but we have already come a long way.

Robert Schwob

London, June 1997

Style Investment Research Associates Limited