

Pan-Europe: What is the Story?

Venet ergo est, “It is sold, therefore it exists”. Doesn’t quite have the ring of *cogito ergo sum*, and I’m sure Descartes never considered it; but *venet ergo est* is a particularly accurate description of how Style is currently being promoted across the global equity markets. And now it’s time to sell the idea of Style across a “unified” (or at least “unifying”) Pan-European market, as well. Does that mean that Pan-European Styles genuinely exist and that we can use the concept constructively in the management of European equity portfolios?

Intuitively, there has to be something to the idea:

- The European economies and markets are becoming more closely linked as EMU approaches in January 1999; and,
- As a recent study from Merrill Lynch reveals, 71% of managers are very soon to invest in Europe as an integrated single market.

But the case still needs to be made.

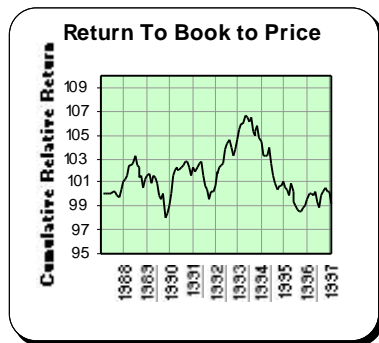
To begin the enquiry, it’s useful to review what we already know about Style in Europe.

- 1 Data are plentiful. There is enough data on over 2000 securities in Continental Europe to conduct a full investigation.
- 2 Style criteria such as Value (Book to Price, Dividend Yield, Earnings Yield), Growth (Return on Equity, Earnings Growth, Profit Margin), Size, Risk, and Momentum can be used to identify groups of securities with distinctive performance characteristics within individual markets.
- 3 Despite the US tradition, Growth stocks within the European markets can not simply be defined as stocks that score low on Value criteria. In the US, portfolios of stocks with low Book to Price scores (called Growth stocks in the US), track very closely to the performance of portfolios of stocks with genuine Growth characteristics (high Return on Equity and high Earnings Growth). But this is not so in Europe. Here it’s generally better to think of stocks with low Value scores as Quality stocks.
- 4 The performance patterns of stocks of similar Styles can be dramatically unsynchronized from market to market. During the latter half of 1997, the UK rewarded Growth, Germany was neutral, and France was in a strong Value phase.
- 5 The principal constituents of the major Styles, and the degree to which they are relevant, differ from market to market. For example, in the UK, the main Value criteria, Book to Price, Dividend Yield, Earnings Yield, etc., are all clearly identified and offer similar reward patterns. In France, the main criteria frequently perform very differently; and in Italy the popular Value criteria do not even define

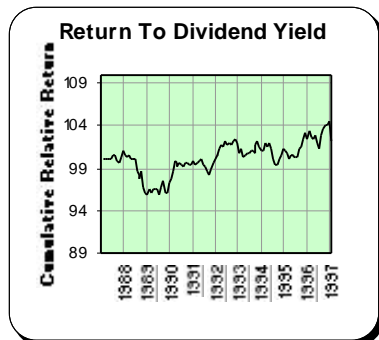
clearly identified Style groups (i.e., The performance of the various groupings of “Value” stocks are not sufficiently distinct from the performance of randomly assembled portfolios.)

Against this background we explore the performance patterns of typical Style groupings across the 10 key Continental European equity markets (Belgium, France, Germany, Italy, Netherlands, Spain, Switzerland, Denmark, Norway, Sweden), taken as a unified market.

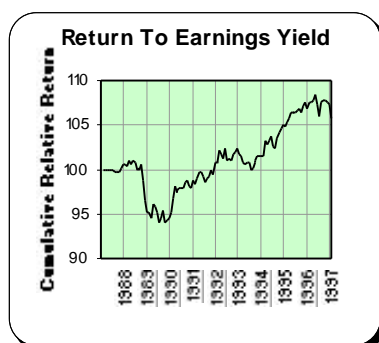
Standard Analysis of Style within the Pan-European Market



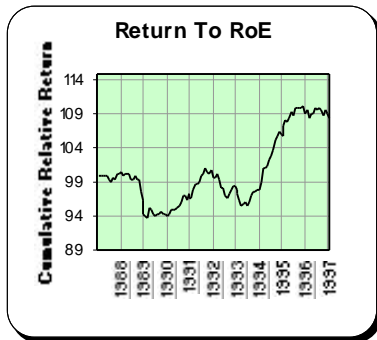
Identity: 100%; Consistency: 19.5%; Regularity: 0.06



Identity: 100%; Consistency: 21.1%; Regularity: 0.01



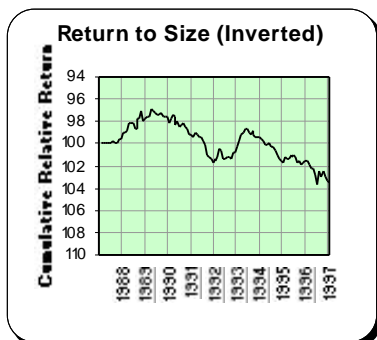
Identity: 100%; Consistency: 34.1%; Regularity: 0.35



Identity: 100%; Consistency: 20.3%; Regularity: 0.55



Identity: 100%; Consistency: 26.3%; Regularity: 0.18



Identity: 100%; Consistency: 6.5%; Regularity: 0.19

The graphs plot the cumulative market-relative total returns earned by regularly rebalanced capitalization-weighted portfolios of stocks scoring high in each factor.

For each factor criterion we also show:

Identity A measure of the clarity of the Style. A high number close to 100% indicates that the performance of the Style is very unlikely to have resulted from random portfolio construction. Consequently, the Style is distinctly identified and therefore relevant.

Consistency The annualized turnover of the factor portfolio. This measures the consistency of the Style factor. It is not necessary, but it is

generally advisable that the stock constituents do not change too rapidly.

Regularity The smoothness of the short-term mean aversion (a positive number) or the short-term mean reversion (a negative number) of the pattern of relative returns. A number close to 0 indicates minimal regularity, erratic performance over the short-term and low prospects of analytical predictability. A high positive or negative number indicates that it may be possible to model the return patterns successfully.

And it's good news. All the Styles have a clear identity. The consistency figures (turnover) are very close to those of individual markets so excessive turnover is not a problem. And, the regularity figures reveal a number of Styles which exhibit medium-term cyclical and so offer considerable potential for further productive research.

So, at first glance, Styles appear to exist despite the lack of market to market synchronization and despite all of our earlier misgivings. And we could be easily drawn to some appealing initial conclusions:

- Book to Price does look difficult to forecast, it's awkwardly erratic over the short-term, and has not performed well over the past 10 years. But it does appear to display longer-term cyclical patterns that can be associated with features of the underlying economies.
- Dividend Yield and Earnings Yield offer improved hope for a positive systematic reward to Value investing.
- Growth criteria look to offer the potential for cyclical Style timers to be successful.
- And, unfortunately, Size is very much as we have come to expect.

But is this really all there is to it? Unfortunately, no. The Style performance patterns also carry a great deal of excess baggage and bias, and we have to take this into account before we can be comfortable about using Style in a live investment environment.

As Tables I and II show, there are enormous differences in financial ratios and key market statistics across the main European markets and across the principal industrial sectors.

TABLE I Financial Ratios across the European Markets (Jan 1998)

	Book to Price	Dividend Yield %	Earnings Yield %	Return on Equity %	Gearing %	Foreign Focus %	Average Size \$b
United Kingdom	0.32	2.6	5.0	126.1	161	42	18.0
Belgium	0.51	2.7	5.4	14.7	500	59	3.5
France	0.45	1.4	2.8	11.5	267	52	6.7
Germany	0.32	1.4	2.9	37.4	350	40	14.9
Italy	0.38	1.3	3.0	19.4	238	26	13.3
Netherlands	0.29	1.9	3.8	21.2	131	54	28.4
Spain	0.40	2.0	4.0	14.8	332	13	8.0
Switzerland	0.29	1.1	2.0	10.5	274	68	34.9
Denmark	0.34	1.3	4.1	15.2	161	68	3.5
Norway	0.47	2.0	7.1	21.2	114	49	2.1
Sweden	0.33	1.8	5.6	22.2	178	78	8.4

TABLE II Financial Ratios across the European Industrial Sectors (Jan 1998)

	Book to Price	Dividend Yield %	Earnings Yield %	Return on Equity %	Gearing %	Foreign Focus %	Average Size \$b
Finance/Ins	0.43	1.7	3.2	15.8	748	25	17.5
Energy	0.33	2.3	4.4	13.2	52	51	66.8
Utilities	0.35	1.8	3.1	11.8	85	7	26.7
Transport	0.37	1.4	1.6	25.8	103	30	6.3
Cons Goods	0.26	1.1	3.0	21.7	70	59	33.6
Cap Goods	0.31	1.4	3.7	21.7	55	66	14.3
Basic Inds	0.50	2.0	4.4	8.0	71	56	8.7

Because of these differences, the various factor portfolios carry significant market and industrial sector concentrations and imbalances. Consequently, the performance characteristics of the constructed Style portfolios are very likely to convey more information about country and industry trends than about Style. And, due to numerous differences, and inversions, in the market rankings, even according to very similar criteria, the story is even more confusing.

Owing to the different rankings and concentrations:

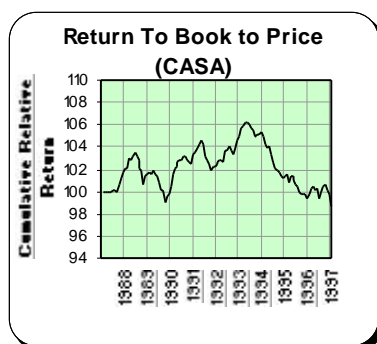
- The Book to Price factor portfolio is overweight in Belgium, France, Germany and Norway, and underweight in the Netherlands.
- The Dividend Yield factor portfolio, an equally important Value portfolio, is overweight in the Netherlands, underweight in France and neutral in Germany.
- And the Earnings Yield portfolio is underweight in Germany.

And looking at the industrial sectors, the story is similarly distorted. Financial Services figure large in Book to Price portfolios but are neutral in other Value portfolios; and the Growth portfolios are overweight in Consumer Goods and Capital Goods.

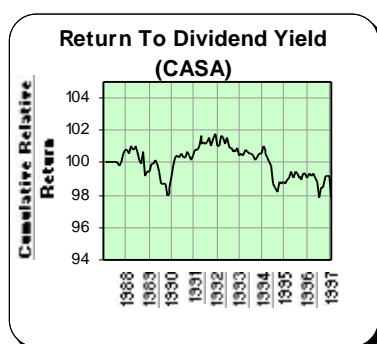
If the Style rewards that we have measured are only disguised industry or market trends, wouldn't it be better to examine the industrial and market trends themselves, directly? And if the Style rewards are genuinely more than that, then shouldn't we try to identify the Style features more clearly?

We have responded to these concerns by redoing the analysis in Country and Sector Adjusted terms. This analysis considers all security factor scores relative to their market and industry factor score averages. A Security is then high in a particular factor only if its score is high for the sector and the market within which the security is classified. (Our analysis systems permit this "adjustment" to be done by industry only or by market only, as well. The results are similarly illuminating.)

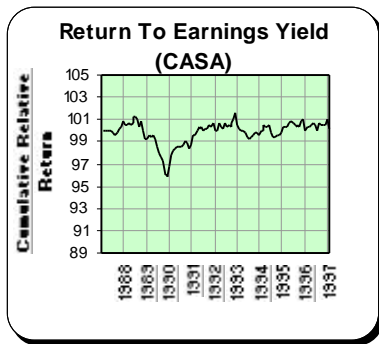
Country and Sector Adjusted Style within the European Market



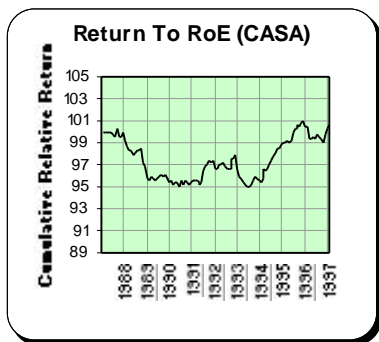
Identity: 100%; Consistency: 25.0%; Regularity: -0.02



Identity: 56%; Consistency: 23.7% Regularity: -0.22



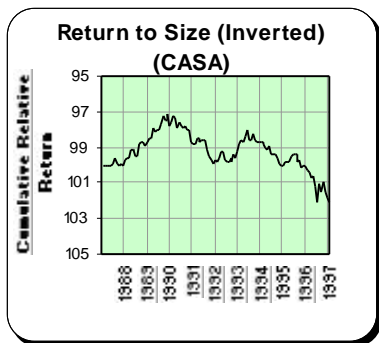
Identity: 100%; Consistency: 37.6%; Regularity: -0.04



Identity: 100%; Consistency: 30.2%; Regularity: 0.20



Identity: 82%; Consistency: 28.0%; Regularity: 0.13



Identity: 100%; Consistency: 7.9%; Regularity: 0.25

On reviewing the key Style criteria:

- Book to Price is clearly identified. It is consequently an important Style which ought to be considered when constructing European equity portfolios. It does look cyclical over the medium term; and a bit of reflection enables us to associate these cycles with underlying economic and market turns. However, the return pattern scores very low in “Regularity”, meaning that it is very erratic over the shorter term, and making formal analysis particularly difficult. Over the longer 10 year term, it has been neutral with the market.
- Dividend yield and Earnings Yield are disappointingly unpromising. Virtually all of the previous potential looks to have been due to market and sector influences. Despite the importance of each of these Style factors in most of the European markets, independently, across Europe as a whole, they appear to “wash out”. This is predominantly due to the asynchronous return patterns of these factors, from market to market.
- Nonetheless, the performance characteristics of the principal Growth criteria are still promising. The Styles are clearly identified and relevant, and there is strong evidence of potentially exploitable cyclicalities, clearly over the medium-term and possibly also over the shorter-term.
- And the Size criterion tells a now very familiar, consistent, and unfortunate story.

Europe is changing very quickly so all findings such as these must be treated with caution. But a number of significant features of European Style do seem to be emerging:

- 1 Despite the scepticism, many (but not all, and not some of the most obvious ones, at that) of the major Styles are clearly identified and potentially exploitable across the Pan European Market ... and they are not simply disguised industry or country effects.
- 2 Often Styles which clearly apply within the individual markets appear to “wash-out” at the Pan-European level of aggregation. This is primarily due to non-synchronous cycles, and that may change as the European markets converge. But, for now, and probably for some time yet to come, it will still be important to explore Style patterns at the individual country level as well.

Returning to our original theme, I don't think that we can yet say with assurance that simple, unified and cohesive Styles apply uniformly across the Pan-European Market. Consequently, *venet ergo est* is clearly not appropriate; and, if it is too broadly applied, it is very likely to be dangerous and hazardous to wealth. So, as far as the simplified Pan-European approach is concerned, *caveat emptor* is probably the most sensible rule to observe. But, as our work has already established, there is clearly something to Pan-European Style and, as the European Market evolves, the area warrants continuing monitoring and research.

Robert Schwob
Dr David Golya
Style Investment Research Associates Limited

London, March 1998