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
Continental shift: The appeal of European equities

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

<table>
<thead>
<tr>
<th>Date of origin</th>
<th>Company and Product</th>
</tr>
</thead>
<tbody>
<tr>
<td>1854</td>
<td>LVMH (Christian Dior)</td>
</tr>
<tr>
<td>1925</td>
<td>Diabetes care company – Novo Nordisk</td>
</tr>
<tr>
<td>1880</td>
<td>Scientific publisher – RELX</td>
</tr>
<tr>
<td>1885</td>
<td>Emerging market FMCG company – Unilever</td>
</tr>
<tr>
<td>1849</td>
<td>Corrective lens supplier – Essilor</td>
</tr>
<tr>
<td>1896</td>
<td>Supplier of cancer medicines – Roche</td>
</tr>
<tr>
<td>1925</td>
<td>Supplier of enzymes – Novozymes</td>
</tr>
<tr>
<td>1874</td>
<td>Supplier of food cultures – Christian Hansen</td>
</tr>
</tbody>
</table>

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
Continental shift

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.

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.
This document is produced by the Global Portfolio Advisory Committee within RBC Wealth Management’s Portfolio Advisory Group. The RBC Wealth Management Portfolio Advisory Group provides support related to asset allocation and portfolio construction for the firm's investment advisors / financial advisors who are engaged in assembling portfolios incorporating individual marketable securities. The Committee leverages the broad market outlook as developed by the RBC Investment Strategy Committee, providing additional tactical and thematic support utilizing research from the RBC Investment Strategy Committee, RBC Capital Markets, and third-party resources.

Global Portfolio Advisory Committee members:
Jim Allworth – Co-chair; Investment Strategist, RBC Dominion Securities Inc.
Kelly Bogdanov – Co-chair; Portfolio Analyst, RBC Wealth Management Portfolio Advisory Group – Equities, RBC Capital Markets, LLC
Frédérique Carrier – Co-chair; Managing Director, Head of Investment Strategies, Royal Bank of Canada Investment Management (U.K.) Limited
Mark Bayko, CFA – Head, Multi-Asset Portfolios & Practice Management, RBC Dominion Securities Inc.
Hakan Enoksson – Head of Fixed Income - British Isles, Royal Bank of Canada Investment Management (U.K.) Limited
Tom Garretson, CFA – Fixed Income Portfolio Advisor, RBC Wealth Management Portfolio Advisory Group, RBC Capital Markets, LLC
Christopher Girdler, CFA – Fixed Income Portfolio Advisor, RBC Wealth Management Portfolio Advisory Group, RBC Dominion Securities Inc.
Jack Lodge – Associate, Structured Solutions team, Royal Bank of Canada Investment Management (U.K.) Limited
Jay Roberts – Head of Investment Solutions & Products, RBC Wealth Management Hong Kong, RBC Dominion Securities Inc.

The RBC Investment Strategy Committee (RISC) consists of senior investment professionals drawn from individual, client-focused business units within RBC, including the Portfolio Advisory Group. The RISC builds a broad global investment outlook and develops specific guidelines that can be used to manage portfolios. The RISC is chaired by Daniel Chornous, CFA, Chief Investment Officer of RBC Global Asset Management Inc.

Additional Global Insight authors:
Dominic Wallington – Head of European Equity, RBC Global Asset Management (U.K.) Limited
**Required disclosures**

**Analyst Certification**
All of the views expressed in this report accurately reflect the personal views of the responsible analyst(s) about any and all of the subject securities or issuers. No part of the compensation of the responsible analyst(s) named herein is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the responsible analyst(s) in this report.

**Important Disclosures**
In the U.S., RBC Wealth Management operates as a division of RBC Capital Markets, LLC. In Canada, RBC Wealth Management includes, without limitation, RBC Dominion Securities Inc., which is a foreign affiliate of RBC Capital Markets, LLC. This report has been prepared by RBC Capital Markets, LLC which is an indirect wholly-owned subsidiary of the Royal Bank of Canada and, as such, is a related issuer of Royal Bank of Canada.

Non-U.S. Analyst Disclosure: Mark Allen, Jim Allworth, Mark Bayko, Christopher Girdler, Patrick McAllister, and Jay Roberts, employees of RBC Wealth Management USA’s foreign affiliate RBC Dominion Securities Inc.; and Frédérique Carrier, Hakan Enoksson, and Jack Lodge, employees of RBC Wealth Management USA’s foreign affiliate Royal Bank of Canada Investment Management (U.K.) Limited; and Dominic Wallington, an employee of RBC Wealth Management USA’s foreign affiliate RBC Global Asset Management (U.K.) Limited; contributed to the preparation of this publication. These individuals are not registered with or qualified as research analysts with the U.S. Financial Industry Regulatory Authority (“FINRA”) and, since they are not associated persons of RBC Wealth Management, they may not be subject to FINRA Rule 2241 governing communications with subject companies, the making of public appearances, and the trading of securities in accounts held by research analysts.

In the event that this is a compendium report (covers six or more companies), RBC Wealth Management may choose to provide important disclosure information by reference. To access current disclosures, clients should refer to http://www.rbc.com/GLDisclosure/PublicWeb/DisclosureLookup.aspx?EntityID=2 to view disclosures regarding RBC Wealth Management and its affiliated firms. Such information is also available upon request to RBC Wealth Management Publishing, 60 South Sixth St, Minneapolis, MN 55402.

References to a Recommended List in the recommendation history chart may include one or more recommended lists or model portfolios maintained by RBC Wealth Management or one of its affiliates. RBC Wealth Management recommended lists include the Guided Portfolio: Prime Income (RL 6), the Guided Portfolio: Dividend Growth (RL 8), the Guided Portfolio: ADR (RL 10), the Guided Portfolio: All Cap Growth (RL 12), and former lists called the Guided Portfolio: Large Cap (RL 7), the Guided Portfolio: Midcap

111 (RL 9), and the Guided Portfolio: Global Equity (U.S.) (RL 11). RBC Capital Markets recommended lists include the Strategy Focus List and the Fundamental Equity Weightings (FEW) portfolios. The abbreviation ‘RL On’ means the date a security was placed on a Recommended List. The abbreviation ‘RL Off’ means the date a security was removed from a Recommended List.

**Distribution of Ratings**
For the purpose of ratings distributions, regulatory rules require member firms to assign ratings to one of three rating categories - Buy, Hold/Neutral, or Sell - regardless of a firm’s own rating categories. Although RBC Capital Markets, LLC ratings of Top Pick (TP)/Outperform (O), Sector Perform (SP) and Underperform (U) most closely correspond to Buy, Hold/Neutral and Sell, respectively, the meanings are not the same because our ratings are determined on a relative basis (as described below).


**Explanation of RBC Capital Markets, LLC Equity Rating System**
An analyst’s “sector” is the universe of companies for which the analyst provides research coverage. Accordingly, the rating assigned to a particular stock represents solely the analyst’s view of how that stock will perform over the next 12 months relative to the analyst’s sector average. Although RBC Capital Markets, LLC ratings of Top Pick (TP)/Outperform (O), Sector Perform (SP), and Underperform (U) most closely correspond to Buy, Hold/Neutral and Sell, respectively, the meanings are not the same because our ratings are determined on a relative basis (as described below).

**Ratings: Top Pick (TP):** Represents analyst’s best idea in the sector; expected to provide significant absolute total return over 12 months with a favorable risk-reward ratio. **Outperform (O):** Expected to materially outperform sector average over 12 months. **Sector Perform (SP):** Returns expected to be in line with sector average over 12 months. **Underperform (U):** Returns expected to be materially below sector average over 12 months.

**Risk Rating:** As of March 31, 2013, RBC Capital Markets, LLC suspends its Average and Above Average risk ratings. The **Speculative** risk rating reflects a security’s lower level of financial or operating predictability, illiquid share trading volumes, high balance sheet leverage, or limited operating history that result in a higher expectation of financial and/or stock price volatility.
Valuation and Risks to Rating and Price Target
When RBC Wealth Management assigns a value to a company in a research report, FINRA Rules and NYSE Rules (as incorporated into the FINRA Rulebook) require that the basis for the valuation and the impediments to obtaining that valuation be described. Where applicable, this information is included in the text of our research in the sections entitled “Valuation” and “Risks to Rating and Price Target”, respectively.

The analyst(s) responsible for preparing this research report received compensation that is based upon various factors, including total revenues of RBC Capital Markets, LLC, and its affiliates, a portion of which are or have been generated by investment banking activities of the member companies of RBC Capital Markets, LLC and its affiliates.

Other Disclosures
Prepared with the assistance of our national research sources. RBC Wealth Management prepared this report and takes sole responsibility for its content and distribution. The content may have been based, at least in part, on material provided by our third-party correspondent research services. Our third-party correspondent has given RBC Wealth Management general permission to use its research reports as source materials, but has not reviewed or approved this report, nor has it been informed of its publication. Our third-party correspondent may from time to time have long or short positions in, effect transactions in, and make markets in securities referred to herein. Our third-party correspondent may from time to time perform investment banking or other services for, or solicit investment banking or other business from, any company mentioned in this report.

RBC Wealth Management endeavors to make all reasonable efforts to provide research simultaneously to all eligible clients, having regard to local time zones in overseas jurisdictions. In certain investment advisory accounts, RBC Wealth Management will act as an overlay manager for our clients and will initiate transactions in the securities referenced herein for those accounts upon receipt of this report. These transactions may occur before or after your receipt of this report and may have a short-term impact on the market price of the securities in which transactions occur. RBC Wealth Management research is posted to our proprietary Web sites to ensure eligible clients receive coverage initiations and changes in rating, targets, and opinions in a timely manner. Additional distribution may be done by sales personnel via e-mail, fax, or regular mail. Clients may also receive our research via third-party vendors. Please contact your RBC Wealth Management Financial Advisor for more information regarding RBC Wealth Management research.

Conflicts Disclosure: RBC Wealth Management is registered with the Securities and Exchange Commission as a broker-dealer and an investment adviser, offering both brokerage and investment advisory services. RBC Wealth Management’s Policy for Managing Conflicts of Interest in Relation to Investment Research is available from us on our Web site at http://www.rbccm.com/GLDisclosure/PublicWeb/DisclosureLookup.aspx?EntityID=2. Conflicts of interests related to our investment advisory business can be found in Part II of the Firm’s Form ADV or the Investment Advisor Group Disclosure Document. Copies of any of these documents are available upon request through your Financial Advisor. We reserve the right to amend or supplement this policy, Part II of the ADV, or Disclosure Document at any time.

The authors are employed by one of the following entities: RBC Wealth Management USA, a division of RBC Capital Markets, LLC, a securities broker-dealer with principal offices located in Minnesota and New York, USA; by RBC Dominion Securities Inc., a securities broker-dealer with principal offices located in Toronto, Canada; by RBC Investment Services (Asia) Limited, a subsidiary of RBC Dominion Securities Inc., a securities broker-dealer with principal offices located in Hong Kong, China; and by Royal Bank of Canada Investment Management (U.K.) Limited, an investment management company with principal offices located in London, United Kingdom.

The Global Industry Classification Standard (“GICS”) was developed by and is the exclusive property and a service mark of MSCI Inc. (“MSCI”) and Standard & Poor’s Financial Services LLC (“S&P”) and is licensed for use by RBC. Neither MSCI, S&P, nor any other party involved in making or compiling the GICS or any GICS classifications makes any express or implied warranties or representations with respect to such standard or classification (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability and fitness for a particular purpose with respect to any of such standard or classification. Without limiting any of the foregoing, in no event shall MSCI, S&P, any of their affiliates or any third party involved in making or compiling the GICS or any GICS classifications have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages.

Disclaimer
The information contained in this report has been compiled by RBC Wealth Management, a division of RBC Capital Markets, LLC, from sources believed to be reliable, but no representation or warranty, express or implied, is made by Royal Bank of Canada, RBC Wealth Management, its affiliates or any other person as to its accuracy, completeness or correctness. All opinions and estimates contained in this report constitute RBC Wealth Management’s judgment as of the date of this report, are subject to change without notice and are provided in good faith but without legal responsibility. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Every province in Canada, state in the U.S., and most countries throughout the world have their own laws regulating the types of securities and other investment products which may be offered to their residents, as well as the process for doing so. As a result, the securities discussed in this report may not be eligible for sale in some jurisdictions. This report is not, and under no circumstances should be construed as, a solicitation to act as securities broker or dealer in any jurisdiction by any person or company that is not legally permitted to carry on the business of a securities broker or dealer in that jurisdiction. Nothing in this report constitutes legal, accounting or tax advice or individually tailored investment advice. This material is prepared for general circulation to clients, including clients who are affiliates of Royal Bank of Canada, and does not have regard to the particular circumstances or needs of any specific person who may read it. The investments or services contained in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about the suitability of such investments or services. To the full extent permitted by law neither Royal Bank of Canada nor any of its affiliates, nor any other person, accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. No matter contained