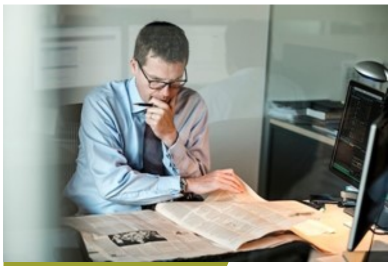


Friday Morning Coffee

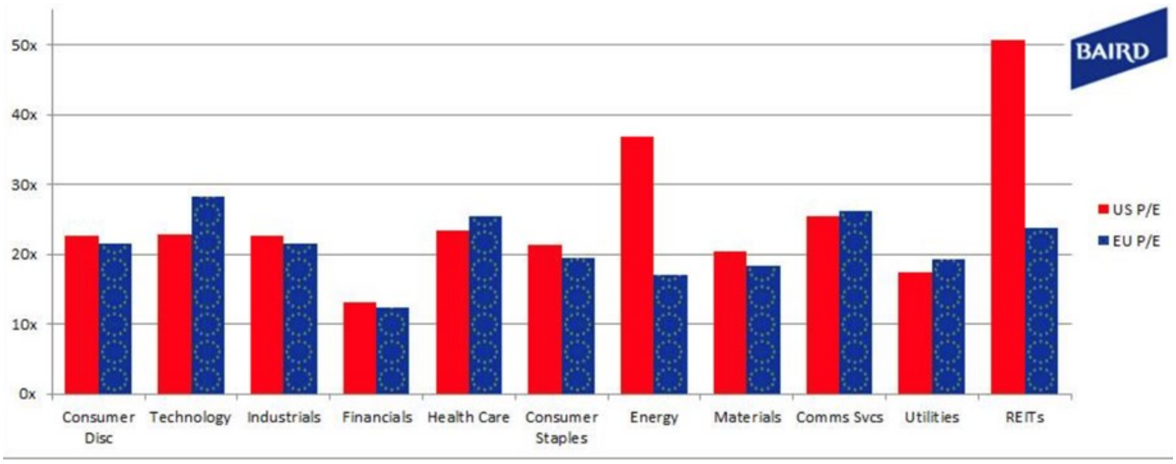
Nr. 116 — Mind the valuation gap

One of the attractions of European equity markets is their valuation gap compared to the US. According to Bloomberg, S&P 500 currently trades at a forward price earnings ratio of 23.2 times versus only 19.2 times for the Europe Stoxx 600. The valuation gap between the US and the old Continent has increased over the last years and is at a record high. However I believe it would be a little too simplistic to reduce the "Why Europe" argumentation to the sole valuation discount argument.

The reason is that the mainstream indices show a distorted reality. On the one hand, the S&P 500 is dominated by a couple of technology companies at lofty valuations. On the other hand, lowly valued financials, industrials and materials carry a relatively higher weight in the Stoxx 600.

A recent FT Alphaville article "Three charts on the price of European equities", Ross Yarrow, Managing Director of US equities at Baird, illustrates the point through 2 graphs.

The first diagram compares the sector valuation in terms of price / earning of the US against Europe. It shows that sector valuations are pretty similar across the most important sectors like consumer, industrials, financials, technology (here Europe even appears more expensive), health care and materials. For the sake of clarity, we can ignore real estate, as this sector represents less than 3% of the market weight.



Source : Baird, FT Alphaville

The valuation difference between the US and Europe stems from the difference in the sector weights. 3 lowly valued sectors, financials, industrials, and energy, carry a significantly higher weight in the European index than in the US. European financials, mainly banks, are in a structurally difficult situation due to shrinking net interest margins in a low interest rate environment, chronic overbanking in Europe and high non-performing loan books. Many investors avoid the energy sector overall due to the depressed oil price and increasing importance of ESG norms.

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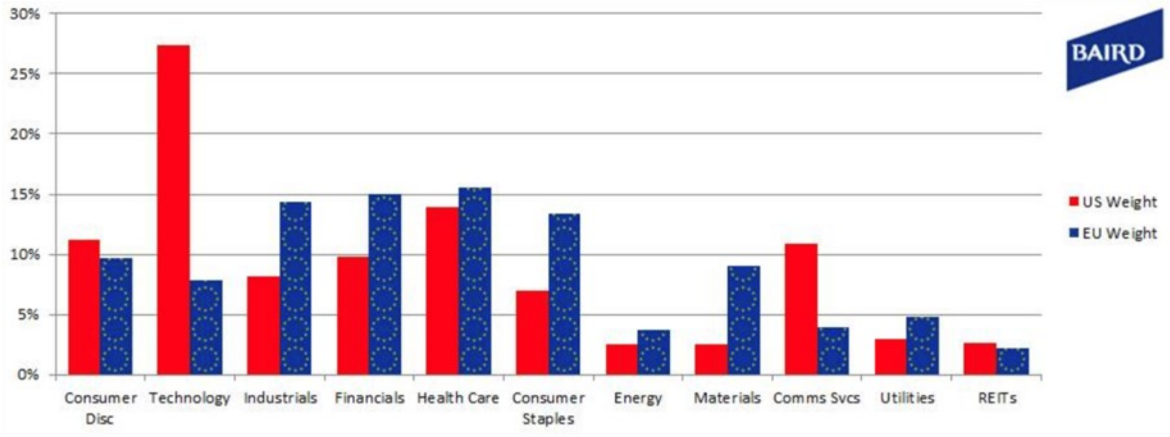

Source : Baird, FT Alphaville

Once you adjust the sector weights of the US market to the ones of the European market, the aggregate valuations are similar.

What do we conclude as value investors ? We invest in companies with undervalued earning power not overall markets. We select stocks not sectors. We are still finding investment opportunities in Europe and have used the sharp fall in asset prices in Q1 to allocate to new names in our portfolio. The pandemic has challenged many businesses and our attention is more than ever on the quality of the underlying businesses. This explains why we needed to sell out of some positions where Covid-19 has challenged the long term fundamentals of the businesses. That is what long term active investing is about. It is not about allocating capital on a pure price / earning basis.

I wish you a nice weekend,

Léon Kirch, CFA

Partner & Chief Investment Officer

August 21 st, 2020