A Spotlight On:
IA Europe

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Introduction to Sector

“We live in uncertain times” a quote by W. Somerset Maugham springs to mind and no wonder. This year, so far to the end of March, the MSCI Europe ex UK index has fallen by -17%, the MSCI UK index is down by -24% and S&P 500 by -14%. The US government’s announcement of a $2 trillion stimulus package on 26th of March has helped the S&P 500 to rally in very recent times. With billions of people still under lockdown, central banks have been cutting interest rates and restarting quantitative easing. Here in the UK, the government has committed to pay a significant portion of workers’ wages, whilst the ECB have committed 750bn euros to asset purchases (7% of GDP), including non-financial corporate debt and Greek sovereigns. How deep and long the recession is going to be this year, given the external shock to economies, as a result of the Coronavirus pandemic, is what economists are currently trying to work out.

Despite significant uncertainties in terms of the outlook, for investors with a long-term horizon who are looking at European equities, such unprecedented times can bring opportunities. Europe is home to thousands of listed companies. These include global businesses and more domestically focused companies, some more sensitive to the economic cycle, others less so. For investors focusing on companies with market capitalisations of more than 500 million euros, there are circa 1400 stocks at the present moment.

With this in mind, in this piece, we are going to look into some of the strategies on offer for UK-based investors. However, before then, we will touch some of the nuances of the IA Europe ex UK peer group.

Sector Nuance

A quick glance at the IA's Europe ex UK sector currently reveals 124 funds from 78 providers (as of the end of March 2020). According to the IA rules, these are funds which invest at least 80% of their assets in European equities and exclude UK securities. This sector includes funds with an income or total return emphasis, passive strategies and funds with growth and value styles. Whilst there are only a handful of funds with an ethical mandate or sustainable focus at the present moment, this is an area of interest for investors, and over time, we expect the number of such strategies to grow.

The MSCI Europe ex UK index itself comprises of 14 developed markets countries in Europe. It currently has 342 constituent companies (as of the end of March 2020) and covers about 85% of the free float-adjusted market capitalisation.

This year to the end of March, the sectors that have held up so far in general (relative to the broader regional index), have been of the more defensive kind, such as utilities, telecommunications, healthcare, consumer goods, but also technology, whilst the worst performers have come from the more cyclical areas of the market, industrials, financials and oil & gas.

Taking a further look into the composition of the index, the technology sector only accounts for about 8% of the MSCI Europe ex UK index, but circa 24% of the S&P 500 and only circa 1% in the MSCI UK index. Financials, however, 15% of the index, versus 12% of the S&P 500 and 19% of the MSCI UK index. Healthcare is the largest sector of the MSCI Europe ex UK index at 18%, this compares to 14% for the S&P 500 and 13% for the MSCI UK index.

Funds in Focus

Given the diverse range of funds with different objectives in the IA Europe ex UK sector, we do not believe that looking at a fund's performance relative to the sector average is useful or indeed relevant. Managers investing in the region can follow a range of different investment styles and it is important to consider this along with their objectives, the process they use to shift through the vast universe to find their stocks, their attitude to risk and the resources/firm support that they can use.

The **BlackRock European Dynamic** fund has a flexible mandate, allowing the co-managers to invest in any European market and sectors where they see the best upside potential. They seek to outperform in a range of market conditions, a challenging objective for any manager to achieve and which may not be realisable in the short run. Nonetheless, we think highly of the lead manager, who has been in charge of the fund since 2008 and who we believe to be a skilled investor. His experience of investing through different market conditions gives him the edge one needs to run this type of strategy.

In general, growth stocks have outperformed value stocks in recent years, and so growth strategies have been popular amongst investors. A fine example is the **Comgest Growth Europe ex UK** fund, which is run by the firm's European equity team of nine portfolio managers and analysts. Comgest is an international asset management group that follow a firm-wide investment approach, to manage quality growth equities over the long term. The bulk of the European team's time is spent on fundamental research, as they believe their edge comes from analysing companies intensively. They typically invest with a long-term time horizon and prefer to run concentrated portfolios (this fund invests in circa 30 to 35 companies). The team's edge is their company analysis, and as such, we would expect that returns are primarily driven by stock contribution, although indirectly sector and country allocation can also have an influence. More broadly, the fund's performance can be highly variable and we would anticipate this fund to do well when the growth style is in favour, but lag in cyclically driven markets.

The **Artemis European Opportunities** fund is a pragmatically run fund with the managers essentially aiming to generate outperformance of the market over time and do so by not being overly wedded to any one particular investment style. Though the managers preference is to purchase high quality growth businesses, they appreciate that there will be times when these look overvalued. As such, they will explore lower quality investment ideas, but these need to be offering very attractive returns and at compelling valuation levels. We have a high regard for managers who have produced an impressive track record of outperformance since the strategy's inception. Though they might lag the index when a particular theme is dominating the market, they will also be likely to avoid the inevitable hangover when the trend reverses.

For those investors who prefer a passive strategy for its low-cost characteristics, the suitability of the index being tracked should be assessed. In this regard, we believe it important to consider the management group's commitment to operating passive strategies, the size of the fund and its historic record of tracking the index.

The **Fidelity Index Europe ex UK** fund aims to track the performance of the MSCI Europe ex UK index. We believe Fidelity have a strong commitment towards managing passive strategies. The fund follows a full replication approach which, as the name suggests, involves purchasing the same securities in the same weights as they appear in the index. Whilst this sounds straightforward, there are subtle differences in the way in which corporate actions, such as changes to the index composition and dividends, are handled by passive fund managers. The impact of these differences on performance is small and is captured in our analysis of the fund's returns.

Value for Money

The chart below highlights the broad spread of costs for the funds in the IA Europe ex UK sector and therefore it caters for all investor types. We believe that such costs should be looked at in terms of value for money and there are a number of factors to consider, such as quality of the management team, their resources and costs that fall outside of the Ongoing Charge Figure (OCF), including trading costs.

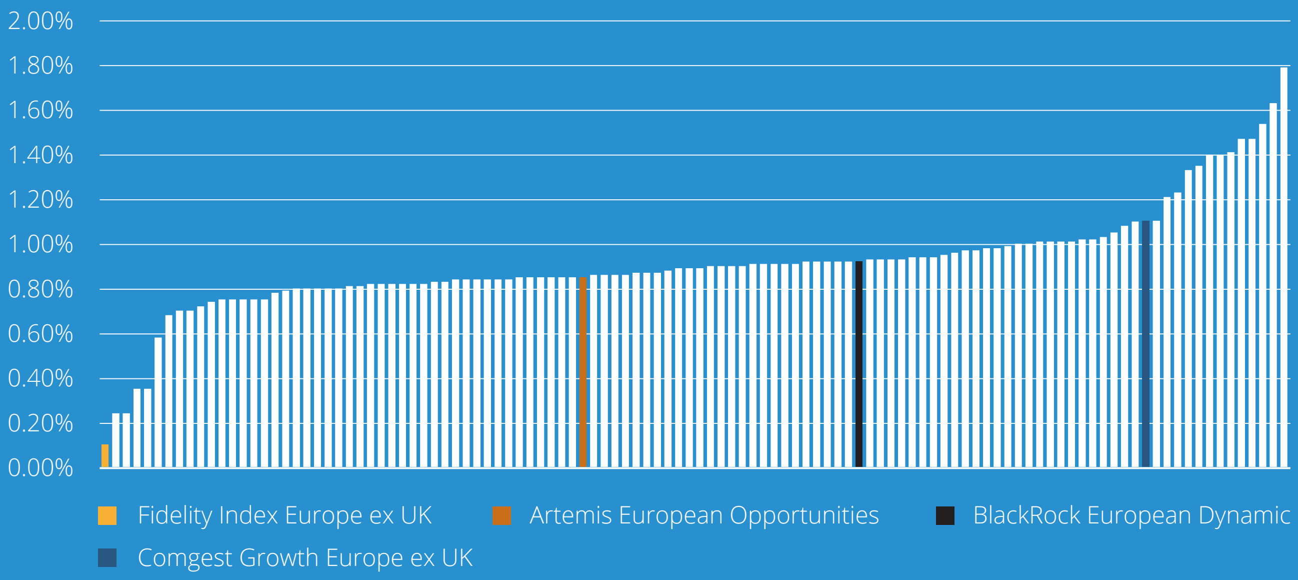

Figure 1: IA Europe ex UK OCFs (excluding passives)

The OCF of the Comgest Growth Europe ex UK fund for the U ACC GBP share class is above the median within the European ex UK active fund universe. Despite this, we believe that over the long term, the team should be capable of outperforming the market, after considering all fees. The BlackRock European Dynamic and Artemis European Opportunities funds are reasonable in terms of their costs and we believe they offer value for money.

We believe the funds we have highlighted above should provide investors with solid exposure to the region, though as mentioned, the European markets can fall foul to periods of low investor sentiment, particularly over shorter time periods. Therefore, any investment made should be considered over the long term.

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