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Is Europe the place to be?

Many investors have fled European stocks, but that may not be the best strategy

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The threat of a bond default by Greece sent tremors through stock markets in May as investors reacted to the prospect of a renewed credit crisis centred on sovereign debt, diminished global growth and even the possible breakup of the European Union. The response of many investors has been to flee equities, particularly European equities.

Yet, based on historical analysis (in Canadian dollars) by my firm, Toronto-based Tacita Capital Inc. , investors who are concerned with long-term, risk-adjusted returns require meaningful exposure to European equities.

The annualized return of the MSCI Europe index from January 1970 through April 2010 was 10.4%, the highest of the broad regional indices in the developed world. It surpassed the 9.8% and 9.7% returns of the S&P 500 index and the S&P/TSX composite index, respectively, as well as the second-place 10% return of the MSCI Far East index over the same period.

The volatility of European equities — with an annualized standard deviation over the 40-year period of 18.1% — was a touch lower than the 18.4% standard deviation of Canadian stocks and much lower than the volatile Far East, with its 23.2% standard deviation. The broadly diversified U.S. stock market was the least volatile, with a 16.3% annualized standard deviation.

Overall, however, on the vital reward-to-variability metric measured by the Sharpe ratio, European equities ranked ahead of Canada, the U.S. and the Far East.

Moreover, European equities had a greater diversification effect on a Canadian investor's portfolio than did U.S. equities. The returns of European equities were less correlated with Canadian stocks than were the returns of U.S. equities. The MSCI Europe index had a 0.55 correlation with the S&P/TSX composite index, lower than the 0.64 correlation of the S&P 500. The MSCI Far East index had the lowest correlation, at 0.32.

The longer-term returns from European equities have also been more stable than those generated by stocks from the U.S. or the Far East. The table above compares the average annual returns of the foreign regional indices for each of the past four decades. As can be seen, the range in returns from Europe is narrower than that from the U.S. and considerably narrower than that from the Far East. Europe did not suffer from the boom-bust cycle of Japan; nor were the excesses of the tech boom as extreme as that which occurred in the U.S.

A contributing factor to the stability of European returns is the higher dividend yield of many European companies. Since 1970, the annualized average income return from European stocks has been 3.7% — higher than the 3.2% and 1.7% average income returns of U.S. and Far East equities, respectively.

European value stocks have paid investors particularly well — since 1975, their income return has been 4.2% per annum. Income-oriented investors need to take note of this opportunity.

Financial advisors have a range of alternatives to propose to clients who want to gain exposure to European equities. One of the simplest strategies is through regionally diversified international and global mutual funds and exchange-traded funds. Advisors will need to analyze these funds to assess their European exposure. **IE**

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