



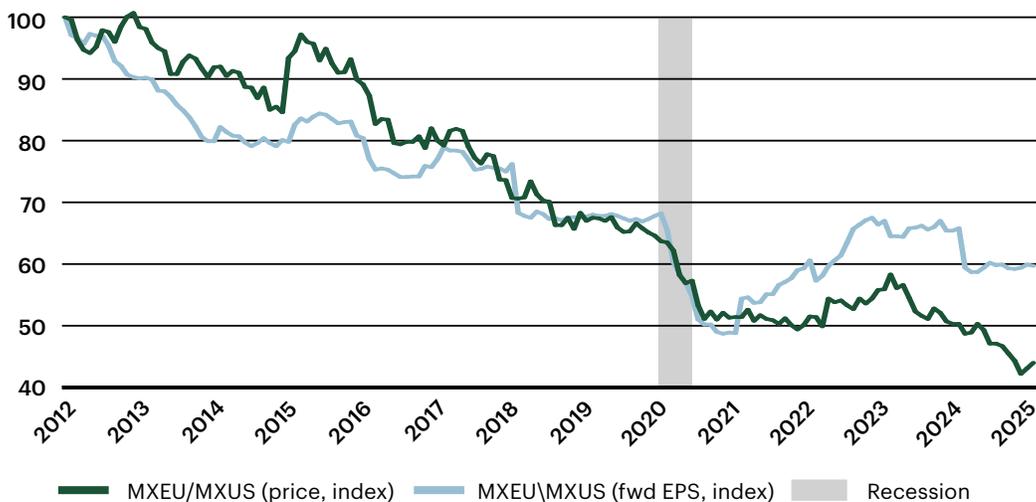
**A Conversation With**  
**Bill Booth, CFA**  
Chief Investment Officer  
and Portfolio Manager,  
TD Epoch

# The Present and Future of European Equities

## What are some of the reasons that Europe has dramatically underperformed the U.S.?

European equities have dramatically lagged the U.S. over the last decade. For the 10 years ended 12/31/24, the MSCI Europe Index has delivered a total return of 72% (in USD). The MSCI USA Index more than tripled that, with a 242% return.

**Figure 1: European Performance and Earnings Relative to U.S.**



Source: Bloomberg Finance L.P.

Europe's underperformance versus the U.S. is primarily due to lower earnings growth. Over the last 10 years, European EPS has grown 44% while the U.S. has grown 81%.

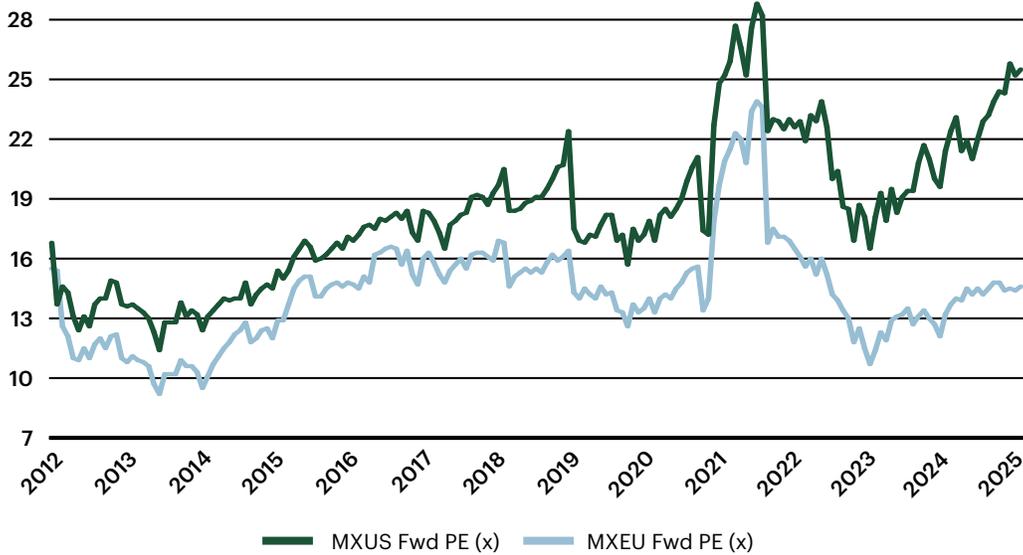
Earnings underperformance in Europe stems from several factors, including slower economic growth versus the U.S. and differences in the makeup and sector weightings of the two equity markets. Slower economic growth is a function of lower productivity, poor demographics, national economies that limit economies of scale, the dual challenges of energy

and national security, and a regulatory state that creates a lack of tech innovation.

Europe's equity underperformance has been exacerbated by a relative valuation decline.

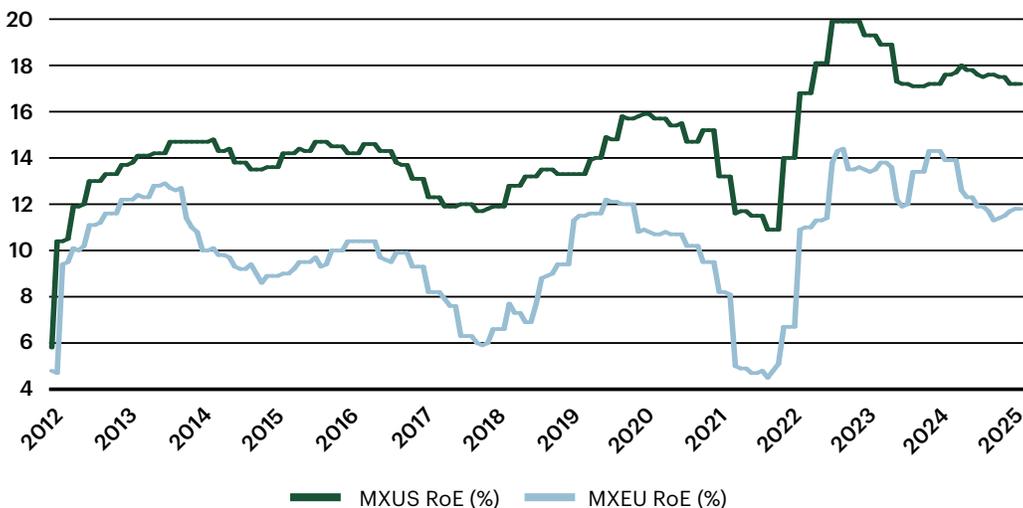
The relative de-rating of Europe reflects a widening of the return on equity (ROE) differential, which has been driven by the increasing profitability of the tech sector in the U.S. For a detailed discussion on why ROE/return on invested capital (ROIC) is so important, please refer to our white paper, "[The P/E Ratio: A User's Manual.](#)"

**Figure 2: Decline in European Valuations**



Source: Bloomberg Finance L.P.

**Figure 3: ROE Differential – Europe vs. U.S.**



Source: Bloomberg Finance L.P.

## What are some of the differences between the European and U.S. equity markets?

Some investors consider the European equity market to be more value based and the U.S. market more growth based. The terms value and growth are terms that are defined differently by different investors and the definitions used by the indices are largely based on traditional accounting measures. TD Epoch defines value based on free cash flow characteristics, rather than on traditional accounting metrics as we discuss in [“What Do We Mean When We Talk About Value?”](#) As we look at it differently, we do not think it is useful to differentiate the European market based on the value and growth labels. It is fair to say, however, that there are significant differences between Europe and the U.S. in terms of sector and industry representation. In the MSCI Europe Index, the largest sector is financials (21%). In contrast, the largest sector in the MSCI USA Index is information technology (32%). In terms of growth, profitability, returns on capital, and long-term fundamental outlook, we believe information technology is far superior to financials. We’d argue the U.S. is a higher quality, higher growth market than Europe.

Sticking with the MSCI indices, the U.S. is also more concentrated than Europe. The top ten constituents in the U.S. account for 35% of the index versus only 21% for Europe’s top 10. This reflects the winner take all dynamics in technology markets and the prominence of tech companies within the U.S. Nine of the top ten companies in the U.S. index are tech or tech-like (e.g. some names may be classified as consumer discretionary or communication services, but are widely considered tech). In contrast, the European top 10 includes companies from tech, health care, consumer staples, energy, consumer discretionary, and financials.

Another difference is from where the companies generate their revenues. While it is true that Europe’s largest companies have global footprints, in aggregate the continent is less exposed to the most attractive economy in the world: the U.S. It is estimated the U.S. accounts for almost 60% of revenue for the MSCI USA Index but only 24% for Europe. Europe also tends to have larger exposure to world trade and China, which is a headwind in the current environment.

## What are some of the regulations that might be limiting Europe?

There is an old adage that the U.S. innovates, China imitates, and Europe regulates. Unfortunately for

investors, there is a lot of truth to this and it is one reason that the technology sector in Europe is not as strong as it is in the U.S. This plays a role in the underperformance Europe as experienced. In fact, a 2022 McKinsey study estimated that 90% of the performance gap between European companies and U.S. companies can be attributed to tech-creating industries.<sup>1</sup> Rather than foster innovation and disruption, European governments tend to protect the status quo. One example of how regulation impacts the tech industry is in labor, where regulations lead to a static labor market where jobs are prioritized over innovation and the obsolescence of particular jobs. The tech industry is fast moving and often requires companies to restructure multiple times, but Europe’s strict labor laws make doing so harder and more costly. For example, for a large enterprise, doing a significant restructuring in the U.S. costs a company the equivalent to two to four months of pay per worker impacted. In France, that cost averages around 24 months of pay. In Germany, 30 months. In total, the restructuring costs are approximately ten times greater in Western Europe than in the U.S. The lack of creative destruction and the attendant birth and death of companies and entire industries is a significant differentiator between Europe and the U.S.

There are also a host of regulations aimed directly at tech companies in Europe including GDPR, the Digital Services Act and the Digital Markets Act among others. According to *The Future of European Competitiveness* written by former Head of the ECB Mario Draghi for the European Commission, the EU now has around 100 tech-focused laws and over 270 regulators active in digital networks.<sup>2</sup> Many of these regulations have a goal of reigning in the tech giants, but what they also do is make it more costly for tech companies to operate in Europe. This, in turn, gives the U.S. tech giants an advantage over smaller, home-grown tech companies in Europe as they have more resources to dedicate to compliance.

## What additional challenges may be on the horizon for Europe

Europe is facing a number of challenges in the years ahead. First, Europe is unlikely to escape the tariff crosshairs of a Trump administration with autos being one of the main industries impacted. In fact, President Trump has indicated that he would like to place a 20% tariff on German automobiles. In Germany, the largest economy in Europe, the automotive industry makes up 17% of German

<sup>1</sup> Securing Europe’s future beyond energy: Addressing its corporate and technology gap, McKinsey Global Institute, May 2022

<sup>2</sup> The future of European competitiveness, Part A, European Commission, September 2024

exports and 5% of its GDP. Second, NATO and defense spending are likely to be a focus under Trump. In his first term, the President placed significant pressure on member countries to meet the 2% of GDP threshold that the organization had set. Currently, only two thirds of the member countries meet that threshold. If the President again pushes for countries to meet and exceed that threshold, as he has indicated he will, it could create further budgetary pressures for major European countries. Third, Europe is feeling the slowdown in China, with Germany especially impacted. China is Europe's second largest export market, with these exports accounting for roughly 1% of its GDP. Sluggish consumption in China will likely impact sectors like manufacturing, luxury goods and, especially, automotive.

Europe is also facing political challenges, with France and Germany being governed by unstable, tenuous coalitions. Populist parties and candidates have garnered increasing support over the last several election cycles. While policy platforms vary, in general there is an anti-big business bent that could inhibit structural reforms that are necessary to promote stronger economic growth and more vibrant capital markets. We should learn more about the political direction of travel with the German federal elections taking place on February 23<sup>rd</sup>.

## **Are there any structural changes underway that may reverse Europe's struggles?**

***i.e. Do we think changing political regimes will be beneficial?***

Europe's relative economic decline is, in part, a direct result of austerity-driven policies that focus on rigidly adhering to budget deficit rules. Reorienting fiscal strategies towards more active demand-side measures that prioritize public and private investment could play a pivotal role in reversing this decline and revitalizing Europe's growth potential.

The European Commission has introduced the "Competitiveness Compass," an initiative to simplify regulation and promote productivity in areas such as AI, biotechnology, and clean energy. One of the aims is to better coordinate the patchwork of policies and support programs that exist across the bloc's 27 member states.

There is some hope that Europe will ease some of its tech regulations, or at least not create new ones that are as stringent. Concerned about Europe's economic growth and lack of competitiveness,

the European Commission requested the study that resulted in The Future of European Competitiveness report mentioned above. In that report Draghi recommended a number of regulatory and non-regulatory paths to strengthening the European tech sector including cutting red tape, coordination of research across member states, better financing for disruptive innovation and boosting access to cloud infrastructure. It remains to be seen what changes might actually be made, but any improvement in Europe's tech sector could help Europe close the performance gap.

## **How do we approach European stocks**

A lot has been made of U.S. exceptionalism. It is remarkable to note the U.S. now comprises 74% of the MSCI World Index, up from 58% a decade ago. One can be forgiven for throwing their arms up and asking, "Why bother with international markets, including Europe?" At an index level, it might be hard to argue for betting against the U.S. But as active managers, we do not own the entire index. In the case of Europe, there are 414 constituents in the MSCI Europe Index. And we'd be the first to admit there is a lot of junk in that universe. But there are also world class businesses that are as good, if not better, than their U.S. counterparts. Companies like the major European aerospace company, which is which is eating the U.S. leader's lunch) to the Dutch semiconductor company that is the only game in town when it comes to advanced semiconductor production equipment and the French industrial company at the forefront of electrification, automation, and energy efficiency.

When looking for investment opportunities in Europe, we tend to focus on global champions. The place a company calls home or where it sets up its corporate headquarters may have little to do with the sources of its revenue, profit, and free cash flow. Rather than focus on where a company "lives," we focus on its fundamental attributes. What competitive advantages does the business have? What is management's track record with capital allocation and creating shareholder value? How does the business model translate into growth, returns on invested capital, and free cash flow generation? While many companies in Europe will fall short of our meeting our desired characteristics, some exceed them. These are the companies we focus on and, when a market is as out of favor as Europe, we can purchase them at relatively attractive valuations.



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