EQUITIES: PERFORMANCE DRIVERS ANALYSIS

Key takeaways

- In the context of the eurozone equity market, total return is defined as the sum of contributions to earnings per share growth, plus changes in share price compared to earnings (P/E) and dividend growth.
- Average annual dividend yield is observably higher than share price yield over the past 20 years, while recording lower volatility than earnings per share.
- During years when the economic climate is undynamic, expanding financial multiples are the main contributor towards capital gains. Conversely, in a situation of broadly distributed growth, EPS growth becomes the leading contributing factor to capital gains.
- The performance gap between the eurozone and the US is chiefly attributable to share buyback programmes. Share buybacks are prioritised over dividend payments as shareholder pay-out in the US, due to their more advantageous tax treatment.
- Dynamic allocation to a variety of performance factors provides better control over total return dispersion in the context of active investment management in the equity market.

Euro equity market performance drivers

The eurozone equity market, as measured by the MSCI EMU index, has returned a 4.71% annualised return, defined as the logarithmic differences of the index values, over the past 20 years (see Chart 1). This period, from 31 December 1998 to 31 December 2020, includes the creation of the eurozone (1999) and the introduction of euro banknotes and coins (2002).

This growth rate masks disparities in momentum between the two main performance drivers: dividends and share prices.

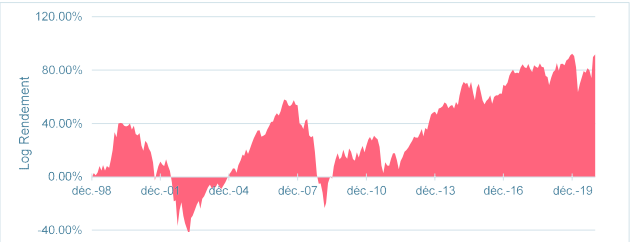

Chart 1: Cumulative log returns of the MSCI EMU Total Return Index. Source: Bloomberg, Ostrum Asset Management.

The total return of a non-amortisable single currency financial asset, such as eurozone equities, breaks down into a price component and a dividend component.

- Price yield is more volatile, as it is composed of capital gains or losses from equity investments;
- Dividend yield provides revenues flows which are not guaranteed over time.

Chart 2 demonstrates that average annual dividend log yield over the past 20 years is 3.04% vs annual price yield of only 1.13%.

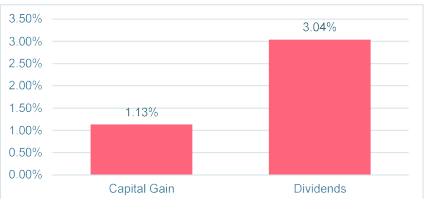

Chart 2: Annual log returns of dividends and capital gains over the last 20 years of the MSCI EMU index. Source: Bloomberg, Ostrum Asset Management.

The relative stability of dividend yield shown in Chart 3 is of notable interest, with recorded volatility of 1.2%, compared to 18.2% for the price component.

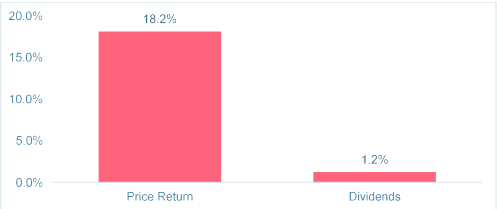

Chart 3: Annualised volatility of the price return and dividend yield on the MSCI EMU index over the last 20 years. Source: Bloomberg, Ostrum Asset Management.

Dividend yield

Chart 4 illustrates annual historic dividend returns compared to total return. Dividend yield was maintained throughout the different market regimes, notably during bear market phases.

Dividend volatility is much lower than earnings per share volatility. The commitment to paying a dividend is a key management decision, which must be sustainable over time and engages managers with regard to the financial community. Earnings cyclicality depends mainly on the economic climate, whereas dividend cyclicality depends on the management's will to reward shareholders. In a poor economic climate, which weighs on earnings per share, the management may increase the earnings pay-out ratio in order to maintain the dividend, or even raise debt (temporarily) in order to guarantee dividend stability. In short, dividends are much less volatile than earnings per share, chiefly on account of the various levers at the company managers' disposal to ensure continued dividend payments.

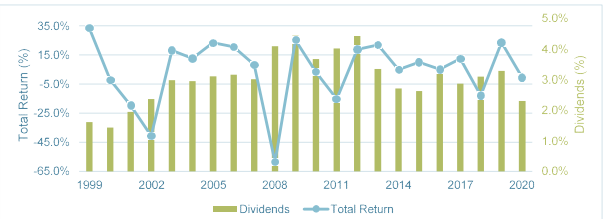

Chart 4: MSCI EMU Index annual log-dividend returns over the last 20 years. Source: Bloomberg, Ostrum Asset Management.

The significant changes occurring over time in the composition of the index must also be taken into account regarding remuneration levels. Chart 5 shows that only 35% of the stocks initially included in the MSCI EMU in 2001 were still in the index in December 2020.

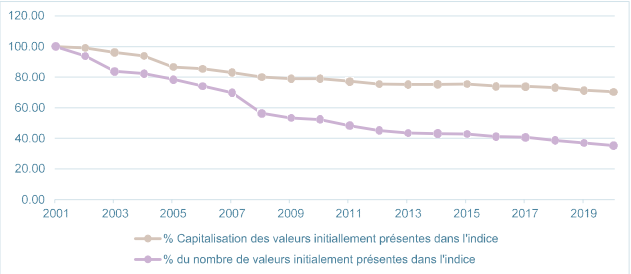

Chart 5: Change in the composition of the MSCI EMU index. Source: Bloomberg, Ostrum Asset Management.

An assessment of the split in total returns between capital gains and dividends in the eurozone equity market reveals that dividends represent the strongest source of performance. As returns from dividends also prove less volatile, despite shocks in the market and variations in turnover among the companies comprising eurozone equities, dividend pay-out can be considered as a regular performance driver.

Capital gains

Capital gains are expressed as the sum of contributions from the expansion of price-earnings ratios (P/E) and earnings growth (EPS). These two factors represent 4.09% and -2.96% respectively as illustrated in Chart 6.

The expansion of financial trading multiples over the period (P/E in the case study) is largely attributable to the constantly sharp easing of interest rates in the eurozone over the past 20 years, due to accommodating monetary policies, and an absence of inflation, resulting from economic globalisation.

The negative contribution from earnings growth appears logical given the eurozone's difficulties in expanding profits over the past 20 years. Unfortunately, the eurozone remains characterised by structural difficulties in generating secular growth. Although there are several reasons for this, the key cause is the difficulty experienced by eurozone companies in expanding turnover, due to weak sales volumes and/or deficient pricing power. In short, few eurozone companies, across all sectors, deliver regular significant gains in market share. Over the past 20 years, US or Asian companies have dominated the leadership in many sectors, to the detriment of the eurozone. This loss of leadership is discernible in the structural difficulties experienced in generating strong earnings growth over the period. The eurozone monetary authorities' resolve to maintain a strong euro compared to other global currencies has certainly also contributed to this phenomenon.

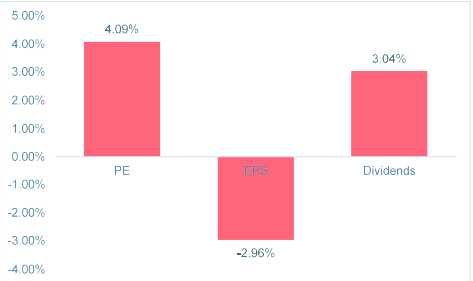

Chart 6: Cumulative log-performance of the different performance drivers of the MSCI EMU index over the last 20 years. Source: Bloomberg, Ostrum Asset Management.

However, returns generated by P/E and EPS are too volatile compared to dividend yields as illustrated in Chart 7.

Chart 7: Annualised volatility on the MSCI EMU over the last 20 years. Source: Bloomberg, Ostrum Asset Management.

The split between the impact from P/E compared to earnings growth has changed significantly over the past 20 years. Chart 8 illustrates the trends observable over a 10-year rolling period which shows changes in the split in total returns between P/E growth and earnings growth. A strong contribution to profits from the EPS factor is clearly observable during economic growth cycles.

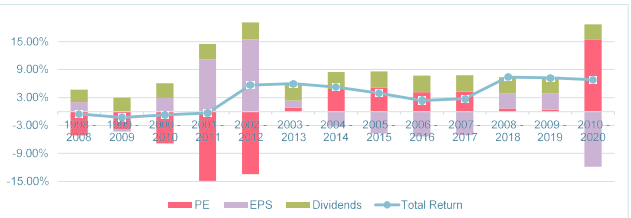

Chart 8: 10-year rolling log-performance of MSCI EMU index performance drivers. Source: Bloomberg, Ostrum Asset Management.

After 2001, when the tech bubble burst and

financial trading multiples contracted, the global economy resumed a strong diverse global growth trend across the board (2002 - 2012). Traded financial multiples logically contracted in a world of more commonplace growth. Economic globalisation and the development of the emerging markets, along with the rise of China as one of the leading global economic powers, have been the key drivers for this expansion phase, which has been favourable to the EPS factor. Investors preferred the most sensitive companies to the resurgent earning cycle, with the strongest potential operational leverage. EPS therefore logically had a greater impact over this period, as this factor attracted investor appetite. With growth as a commonplace highly diversified factor, investors had no need to overpay for growth through expanding financial multiples.

Conversely, from 2010 - 2020, global economic growth was more chaotic, less diverse and concentrated in Asia and the US. The eurozone was impacted by the peripheral sovereign debt crisis, which triggered budgetary tightening by most member states, which curbed growth in the region. ECB monetary policy became more accommodating during the latter part of this period however, driving interest rates sharply lower. In this context of sluggish regional growth, coupled with extremely low interest rates, the "multiple expansion" or PE factor logically contributed positively to eurozone equity performances. In a situation where growth is rare, investors focus solely on companies characterised by sustainable secular earnings growth, with clear visibility and strong resilience. Financial trading multiples expanded significantly as a result among these so-called growth companies.

It should be noted that this split varies over time. A more detailed analysis in Chart 9 reveals distinct divergences, from one year to the next, between the P/E effect and the impact of earnings on returns. This is particularly the case during stock market crashes, such as during the various financial crises which have hit the market, characterised by strong temporary risk aversion among investors who resort to fundamental growth stocks.

This same phenomenon occurs year after year, i.e. during periods when the economic climate is undynamic, for whatever reason, financial multiples expansion is the main capital gains driver. As growth is rare, investors scramble into the few companies generating structural earnings growth. This investor behaviour causes financial trading multiples to surge (2012 and 2020). Conversely, in situations of more widespread growth, investments do not need to be concentrated among the few companies enjoying secular growth. investors therefore focus on companies with the strongest leverage to amplify their earnings and the EPS growth factor then becomes the main capital gains driver (2009 and 2003).

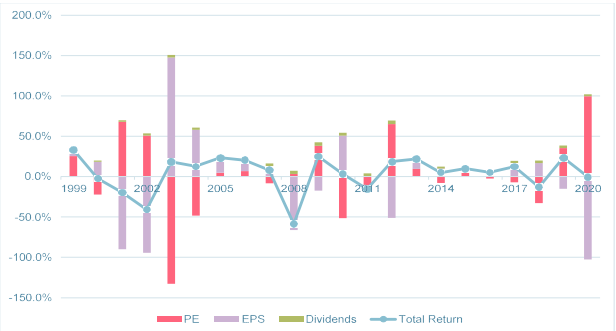

Chart 9: Annual log returns of MSCI EMU performance drivers over the last 20 years. Source: Bloomberg, Ostrum Asset Management.

During the 2001 and 2007 financial crises, earnings growth appears to have fallen in parallel with the equity market, while P/E expansion trended higher symmetrically over the same periods. Chart 10 illustrates the aggregated performance gaps over these periods.

Chart 10: Cumulative log-performance of P/E expansion and earnings growth. Source: Bloomberg, Ostrum Asset Management.

This global trend is confirmed by an analysis of correlations between performance factors:

	Price Return	EPS Return	PE Return	Dividends Return
Price Return		0.14	0.17	-0.06
EPS Return	0.14		-0.95	0.02
PE Return	0.17	-0.95		-0.04
Dividends Return	-0.06	0.02	-0.04	

Table 1: Correlations of the performance components of the MSCI EMU index over the last 20 years. Source: Bloomberg, Ostrum Asset Management.

During the review period, there is a strong negative correlation between P/E yield and earnings yields (-0.95) while capital gains appear to be marginally correlated with dividend yield (-0.06).

Comparison with the US market

As a comparison, Chart 11 reproduces the same split in US equity market total returns over the past 20 years as reflected in the S&P 500 index.

An observation of the returns from the different performance drivers in the US reveals a significant divergence with the eurozone market.

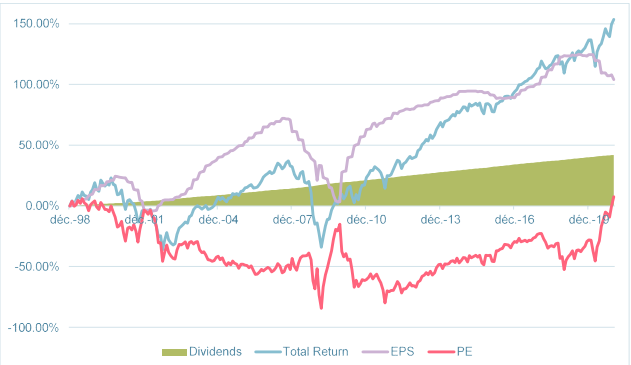

Chart 11: Cumulative log-performance of the various S&P500 index performance drivers. Source: Bloomberg, Ostrum Asset Management.

The US market delivered a total log-performance of almost 7%. Chart 12 shows the contribution from different performance drivers, demonstrating that capital gains far outpace dividend performance (+5.1% vs +1.9%), illustrating a sharp difference in allocation profitability between the eurozone and the US markets.

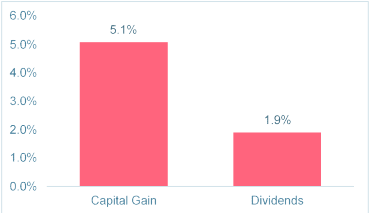

Chart 12: Annualised log price and dividend performance of the S&P500 index over the last 20 years. Source: Bloomberg, Ostrum Asset Management.

The lesser importance of the dividend factor in the US market equity performance results from the fact that American company managers prioritise share buybacks over dividend payments as a means of remunerating their shareholder base, on account of their more advantageous tax treatment. This is a key element to take into account. This factor is the main cause of the difference in returns between the eurozone and US. Capital gains are boosted by share buybacks, particularly earnings growth per share, due to the reduction in the number of shares.

Furthermore, in contrast to the eurozone market, capital gains are represented mainly by earnings growth (+4.7%) whereas P/E expansion remains at +0.4% over the review period.

Unlike the eurozone, the US is always characterised as a highly diversified strong growth region, where widespread structural growth is not rare. The US is the originator and chief beneficiary of economic globalisation. Disruptive technological, societal and/or regulatory phenomena have always boosted American companies and their earnings growth. The proportion of US companies boasting global economic leadership has not diminished, unlike Europe and more particularly the eurozone.

Therefore, in a situation where secular growth is not rare, investors have no reason to focus their investments and therefore their performances on a limited number of companies, which would result in driving trading multiples higher. Investors have polarised on American companies with the greatest exposure to growth, as investment supports providing strong earnings growth are always available.

Conclusion

In the context of the eurozone equity market, total return is defined as the sum of contributions to earnings per share growth, plus changes in share price compared to earnings (P/E) and dividend growth.

Over a relatively long-term horizon, the eurozone market performance split is observably chiefly linked to regular dividend payments, which therefore represent a particularly attractive type of remuneration for eurozone investors.

Capital gains however, which are an expression of the interaction between P/E and earnings growth, are subject to market regimes which may strongly impact P/E or earnings growth expansion. This implies that dynamic allocation to a variety of performance factors provides better control over total return dispersion in the context of active investment management in the equity market.

Furthermore, the performance gap between the US and the eurozone markets in this analysis results from divergent conduct and intensity among the underlying performance drivers during the different equity market phases over the past 20 years. A marked gap therefore exists, in terms of total return split, which must be fully understood in each of the investment regions.

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ADDITIONAL NOTES

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