

How European is Europe?

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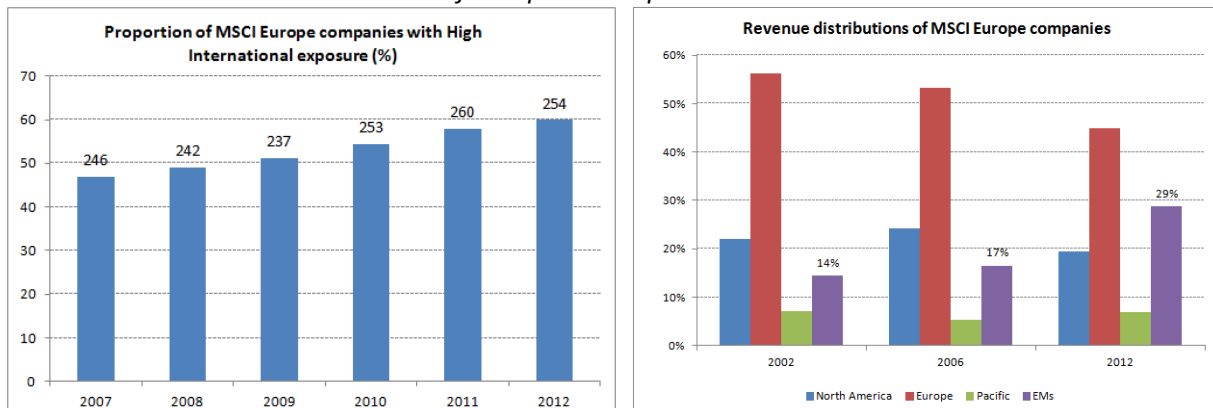
The ongoing sovereign debt crisis in Europe coupled with political uncertainty has pushed Europe into a deep recession posing enormous challenges not just for countries but also companies. However, some European companies have been able, to varying degrees, to rise above these domestic challenges and expand their footprint globally. Furthermore, with the decoupling of economic growth across global regions, understanding where companies derive their revenues is increasingly becoming an important consideration for global investors. This prompts the question, **How European is Europe?**

In this article, we address this question by analyzing the economic exposures of a fairly diverse universe of European companies to different countries and regions and uncover which companies, sectors and even countries have increased their revenues across different global regions and which have remained largely tied to the European economy. The study draws upon the recently launched MSCI Economic Exposure Security Data modules that provide revenue exposures for nearly 2,500 large- and mid-cap companies in the MSCI ACWI Index, a global equity index consisting of developed and emerging market countries, and offers fresh insights on the applications of economic exposure data in investment policy, active portfolio construction and risk management.

European Companies, At Home in the World

Many European companies across different industries—such as Unilever, Siemens and LVMH, to name a few—have been at the vanguard of globalization over the last two decades and exhibit considerable diversity in their geographic scope today. Exhibit 1 shows that over the last five years, the percentage of European companies with high international exposure¹ has risen from 47% in 2007 to 60% in 2012. Another striking fact is the high economic exposure of European companies to emerging markets that has risen from 14% in 2002 to nearly 29% in 2012.

Exhibit 1: Trends in the Globalization of European Companies



¹ High international exposure refers to companies deriving more than 30% of their revenues outside Europe. Data as of Dec 2012.

Economic exposure analysis can shed new light on the geographic exposures of investment mandates. Exhibit 2 shows the economic exposures of the MSCI AC Europe Index, a broad regional index covering developed and emerging markets in Europe, as of December 2012. While the UK has a market cap weight of nearly 33% in the MSCI AC Europe Index, the economic exposure of the index to the UK is much lower at 11%. Similarly Europe ex UK has a market capitalization weight of nearly 62% in the MSCI AC Europe Index whereas the economic exposure to Europe ex UK is far less at 40%. Further, the international exposure (ex-Europe) is nearly 39%, with a North American exposure of 16% and an emerging markets (EM) exposure of 28%.

Exhibit 2: Economic Exposures of the MSCI AC Europe Index as of December 2012

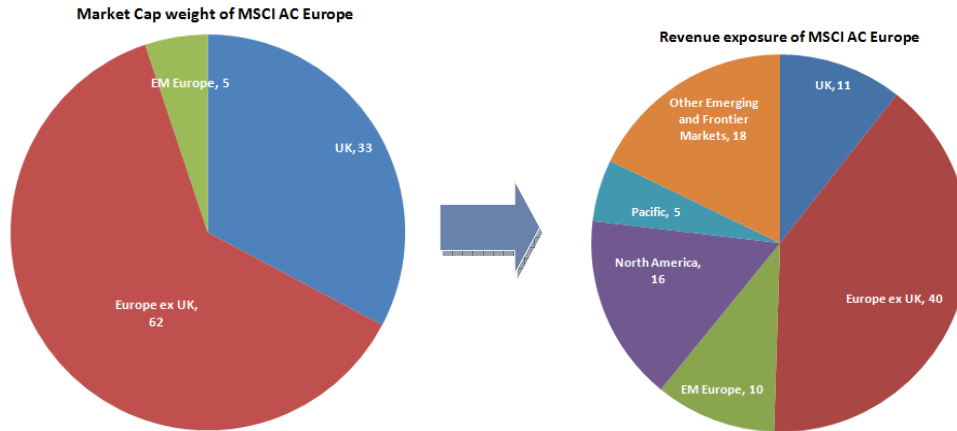


Exhibit 3 shows the economic exposures of different countries in Europe to various regions as of December 2012. Countries such as Portugal, Norway, Greece, Spain and Italy have the highest domestic exposure whereas countries such as Ireland, Sweden, Switzerland, Finland, Denmark and UK have the lowest domestic exposures on this date. Norway, Greece, Portugal, Spain and Italy are the countries with highest exposures to Europe. Based on ex-Europe exposures, Netherlands, Belgium, Switzerland, UK and Sweden have the highest international exposures (to North America and emerging markets). Further, countries such as Austria, Greece, Finland, Spain and Denmark have the highest exposures to emerging markets whereas Norway and Italy have the lowest exposures. Across the emerging markets in Europe, Hungary and Russia have the lowest domestic exposures.

Exhibit 3: Distribution of Economic Exposures of European Countries as of December 2012

Country	Country weight	Domestic exposure	North America	Europe	Japan	Pacific ex Japan	EM Europe	Other Emerging and Frontier Markets	Other
UNITED KINGDOM	32.8	25	21	43	5	2	4	20	3
FRANCE	13.9	30	12	59	3	1	5	16	3
GERMANY	12.7	27	15	56	3	2	6	15	2
SWITZERLAND	12.6	12	25	42	4	2	4	19	4
SWEDEN	4.6	10	17	46	4	3	5	21	5
SPAIN	4.4	39	7	58	1	2	3	26	3
NETHERLANDS	3.6	19	26	45	4	1	4	17	3
ITALY	3.3	31	15	59	2	1	5	15	3
BELGIUM	1.7	26	28	46	1	1	5	17	3
DENMARK	1.7	20	12	51	5	2	6	22	3
NORWAY	1.3	55	10	73	1	1	2	11	2
FINLAND	1.1	20	6	53	3	2	8	23	4
AUSTRIA	0.4	30	2	54	1	2	20	18	4
IRELAND	0.4	3	27	40	4	1	5	19	4
PORTUGAL	0.3	56	1	77	0	0	11	10	0
GREECE	0.1	39	0	62	0	0	26	8	4
EUROPE	94.9		17	52	3	2	5	18	3
RUSSIA	3.1	50	6	23	2	1	52	12	4
TURKEY	1.0	90	1	4	1	0	92	2	1
POLAND	0.8	69	3	13	1	0	74	8	2
CZECH REPUBLIC	0.1	84	1	1	0	0	85	11	3
HUNGARY	0.1	35	1	22	0	0	46	20	10
EM EUROPE	5.1		5	19	2	1	61	10	3
AC EUROPE	100.0		15	49	3	2	10	17	3

Exhibit 4 shows the distribution of economic exposures of different sectors in the MSCI Europe Index as of December 2012. Notably, Utilities, Telecommunications Services and Financials have the highest domestic exposures to Europe, whereas Health Care, Information Technology and Materials have the highest international exposures on this date. Health Care companies in Europe have high exposure to the USA while Information Technology and Materials companies have high exposure to emerging markets².

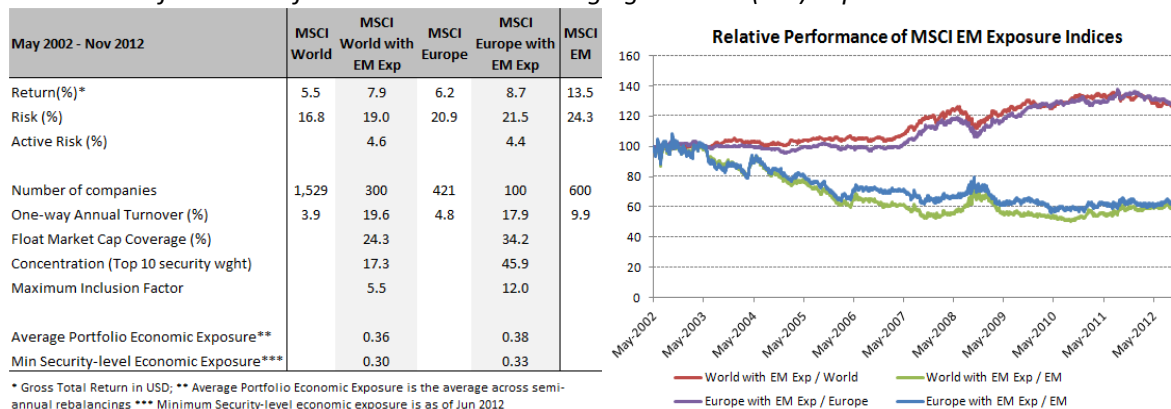
Exhibit 4: Distribution of Economic Exposures of Sectors in the MSCI Europe Index as of December 2012

Region	North America	Europe	Japan	Pacific ex Japan	EM Europe	Other emerging and frontier markets	Other
Europe	16	52	3	2	5	18	4
Information Technology	15	36	5	6	5	29	5
Energy	19	46	4	2	5	19	5
Telecommunication Services	8	65	1	1	6	17	3
Industrials	18	47	4	4	5	18	4
Consumer Staples	14	53	3	1	6	20	3
Health Care	34	33	7	2	5	16	4
Financials	16	60	2	2	4	13	2
Consumer Discretionary	19	49	4	2	6	18	3
Materials	17	34	7	2	6	29	5
Utilities	7	81	0	0	4	6	1

The Pursuit of Emerging Markets Growth

As many emerging markets continue to post robust growth, several European companies are benefiting from the economic growth in these markets. Economic exposure data may be extremely relevant to active managers with a fundamentally driven investment process. For example, active managers may implement macroeconomic views and themes in their portfolios with an aim to access economic growth in specific regions such as emerging markets.

Exhibit 5: Performance of MSCI Indices with Emerging Markets (EM) Exposure



The MSCI Indices with EM Exposure represent the opportunity set of companies in developed markets (DM) with high economic exposure to emerging markets (EM). The MSCI Indices with EM Exposure may provide global investors with a basis for an alternative approach for obtaining EM exposure where EM

² The regions North America, Europe, Pacific ex Japan, EM Europe and other emerging and frontier markets are based on MSCI definitions. 'Other' refers to countries not followed by MSCI.

investment constraints exist due to regulation, accessibility issues or to potential governance concerns. Exhibit 5 shows the historical performance characteristics of the MSCI Europe with EM Exposure and the MSCI World with EM Exposure Indices. The average EM economic exposure of the MSCI Europe with EM Exposure Index is 38% over the period between May 2002 and November 2012. The MSCI Europe with EM Exposure Index outperformed the MSCI Europe Index (by about 2.5% on an annualized basis) with comparable risk and with a tracking error of 4.4% over the observation period between May 2002 and November 2012.

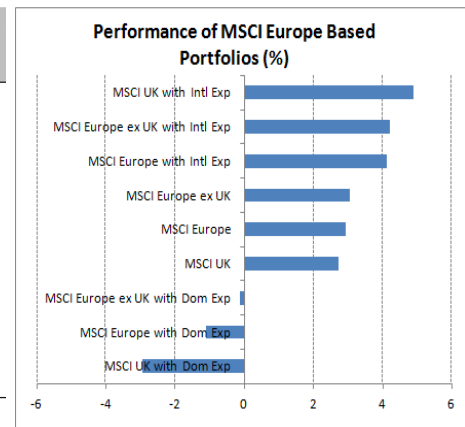
Navigating Risks within European-based Portfolios

Given the wide dispersion in economic exposures across firms in Europe, active managers may be able to implement risk based macroeconomic views in their portfolios using economic exposure data by gearing the portfolios away from specific regions or countries (with macroeconomic or geopolitical risk), with an aim to achieve superior risk-adjusted performance. Exhibit 6 compares the performance of three sample portfolios of European companies with high domestic and high international exposures. Based on historical back-calculated performance, the sample portfolios of European companies with international exposure exhibited higher performance with lower risk compared to sample portfolios of European companies with domestic exposure over the observation period.

Exhibit 6: Performance of Sample European-based Portfolios with Domestic and International Exposures

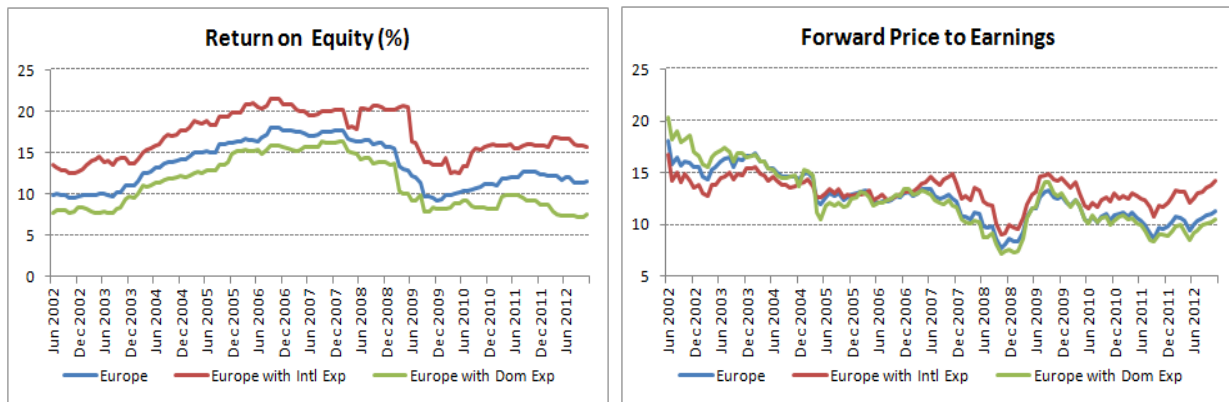
May 2002 - Nov 2012	MSCI Europe	MSCI Europe with Dom Exp	MSCI Europe with Intl Exp	MSCI Europe ex UK	MSCI Europe ex UK with Dom Exp	MSCI Europe ex UK with Intl Exp	MSCI UK	MSCI UK with Dom Exp	MSCI UK with Intl Exp
Return(%)*	2.9	-1.1	4.1	3.0	-0.1	4.2	2.7	-2.9	4.9
Risk (%)	16.5	19.1	15.2	18.0	20.2	16.4	15.1	19.5	16.1
Active Risk (%)		5.5	4.9		4.8	6.0		9.0	6.3
Portfolio characteristics									
Number of companies	422	175	90	316	150	60	106	50	25
One-way Annual Turnover (%)	4.8	14.4	14.1	3.4	12.9	15.0	2.2	9.6	17.9
Float Market Cap Coverage (%)		31.0	31.9		42.1	26.9		34.2	34.8
Maximum Inclusion Factor*		5.4	5.8		4.3	7.1		6.4	4.6
Average Portfolio Economic Exposure		89.6	72.5		81.8	74.4		76.3	95.6
Min Security-level Economic Exposure**		63.6	63.3		54.6	66.4		17.2	94.1

* Gross Total Return in EUR ** Portfolio characteristics are usually average figures across rebalancings * Maximum Inclusion factor across rebalancings ** Minimum Security-level economic exp as of Jun 2012



Furthermore, the sample portfolios of European companies with international exposure exhibited higher ROE and forward P/E multiples in comparison to the MSCI Europe Index and the sample portfolios of European companies with domestic exposure over the observation period from June 2002 to November 2012.

Exhibit 7: Valuation and Return on Equity (ROE) of European-based Portfolios



Conclusion

With increasing globalization, many European companies have been able to weather the challenges of a domestic recession in Europe and have been successful at growing revenues across international markets. Our analysis of the economic exposures of a broad universe of companies domiciled in Europe highlights that the constituents of the MSCI Europe Index had nearly 48% international exposure and nearly 23% exposure to emerging markets as of December 2012, underscoring the global profile of many European companies.

In addition, with the decoupling of economic growth across regions, understanding the economic exposures of companies to different regions and countries is increasingly becoming an important factor in the construction and evaluation of global equity portfolios. With economic exposure data, active managers may implement macroeconomic views and themes in their portfolios in seeking to access potential economic growth in specific regions such as emerging markets. Further, it may be possible to implement risk-based macroeconomic views in a portfolio by gearing it away from specific regions or countries (with macroeconomic or geopolitical risk) in an effort to achieve superior risk-adjusted performance. The recently launched MSCI Economic Exposure Security Data modules can potentially support multiple needs of asset owners, asset managers, broker-dealers and risk managers in the investment process: in the analysis of the exposure of investment mandates, in active portfolio construction and in risk management.

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The company's flagship product offerings are: the MSCI indices with close to USD 7 trillion estimated to be benchmarked to them on a worldwide basis¹; Barra multi-asset class factor models, portfolio risk and performance analytics; RiskMetrics multi-asset class market and credit risk analytics; IPD real estate information, indices and analytics; MSCI ESG (environmental, social and governance) Research screening, analysis and ratings; ISS governance research and outsourced proxy voting and reporting services; FEA valuation models and risk management software for the energy and commodities markets; and CFRA forensic accounting risk research, legal/regulatory risk assessment, and due-diligence. MSCI is headquartered in New York, with research and commercial offices around the world.

¹As of March 31, 2012, as published by eVestment, Lipper and Bloomberg in September 2012