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EUROPEAN MARKET COMMENT: HOUSEHOLD EQUITY OWNERSHIP TRENDS

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Robert Lang
William Nasgovitz

Household Equity Ownership Trends in Europe:
Under-Owned, Under-Developed, and Perhaps Over-Exaggerated

Household ownership of equities in Europe is relatively low, but has been increasing steadily over the last decade. European households tend to own equities indirectly, via mutual funds and insurance contracts, rather than through direct holdings (see Table A). These ownership patterns can be attributed to various social institutions—for example, the absence of tax incentives for owning equities, generous government pension plans that inhibit the growth of private savings plans, and the relatively undeveloped state of Europe's public equity markets (see Table B) compared to those in the United States (primarily because European firms have historically relied on banks rather than the capital markets for their financing).

Accordingly, individual businesses and housing comprise the bulk of total assets of European households. In 1999, net financial assets represented only 42% of their total net worth, relative to 67% in the United States, and most of these assets have been invested in money markets and bonds rather than in equities. The value of European households' equity holdings, direct and indirect, equals roughly six months of disposable income, whereas the comparable ratio for American households that own equities is about two and a half years.

Shares, Mutual Funds, and Pensions

As indicated in Table A, German share ownership as a percentage of total financial assets has more than doubled over the last decade, growing from 8.6% to 16.5% as of year-end 2000.[1] In the United Kingdom, share ownership has remained roughly in the 16% to 20% range from 1990 to September 2001, while in France, it has remained virtually unchanged from 1995 to 2000, rising from 4.9% to 5.0%. In comparison, share ownership in the United States ballooned from 16.1% in 1990 to 37.2% in 1999, before shrinking to 25.7% by September 2001.

Mutual fund ownership as a percentage of total financial assets grew rapidly in Europe in the last decade, except in France, where it fell from 14.2% to 11.0%. In Germany and the United Kingdom, it nearly tripled, rising from 5.5% to 15.6% and 3.7% to 9.7%, respectively. In comparison, mutual fund ownership in the United States rose from 4.1% to 12.0%. In addition, European-based mutual funds themselves have increased their exposure to equities, though these levels remain low relative to those of

[1] It is difficult to compare equity ownership patterns among European countries (and the United States), because the central banks and other data sources neither consistently nor clearly define the various ownership categories. After closely analyzing the definitions, we nevertheless believe the overall patterns presented in this report offer an accurate picture, although the precise figures may not be strictly consistent across countries. See the sources and notes in Table A for more details.

the United Kingdom and United States. In continental Europe, from 1992 to September 2000, equity allocation among all mutual funds grew from 18% to 49%, while in the United Kingdom, mutual funds hold about 82% of their holdings in equities, and in the United States, 60%.

Households own equities indirectly through pension funds and insurance funds and in continental Europe both types of funds have expanded their allocation to equities as a percentage of total assets in recent years. For example, pension fund allocations to equities rose from 40% in 1993 to 47% in 1999, while insurance funds expanded their allocations from 15% in 1995 to 19% in 1998. In the United Kingdom, pension funds have tended to hold more equities, though allocation levels fell from 83% in 1993 to 72% in 1999, as the introduction of the Minimum Funding Requirement induced funds to increase the allocation to gilts—a trend likely to continue.

How Will Changing Ownership Patterns Affect Equities?

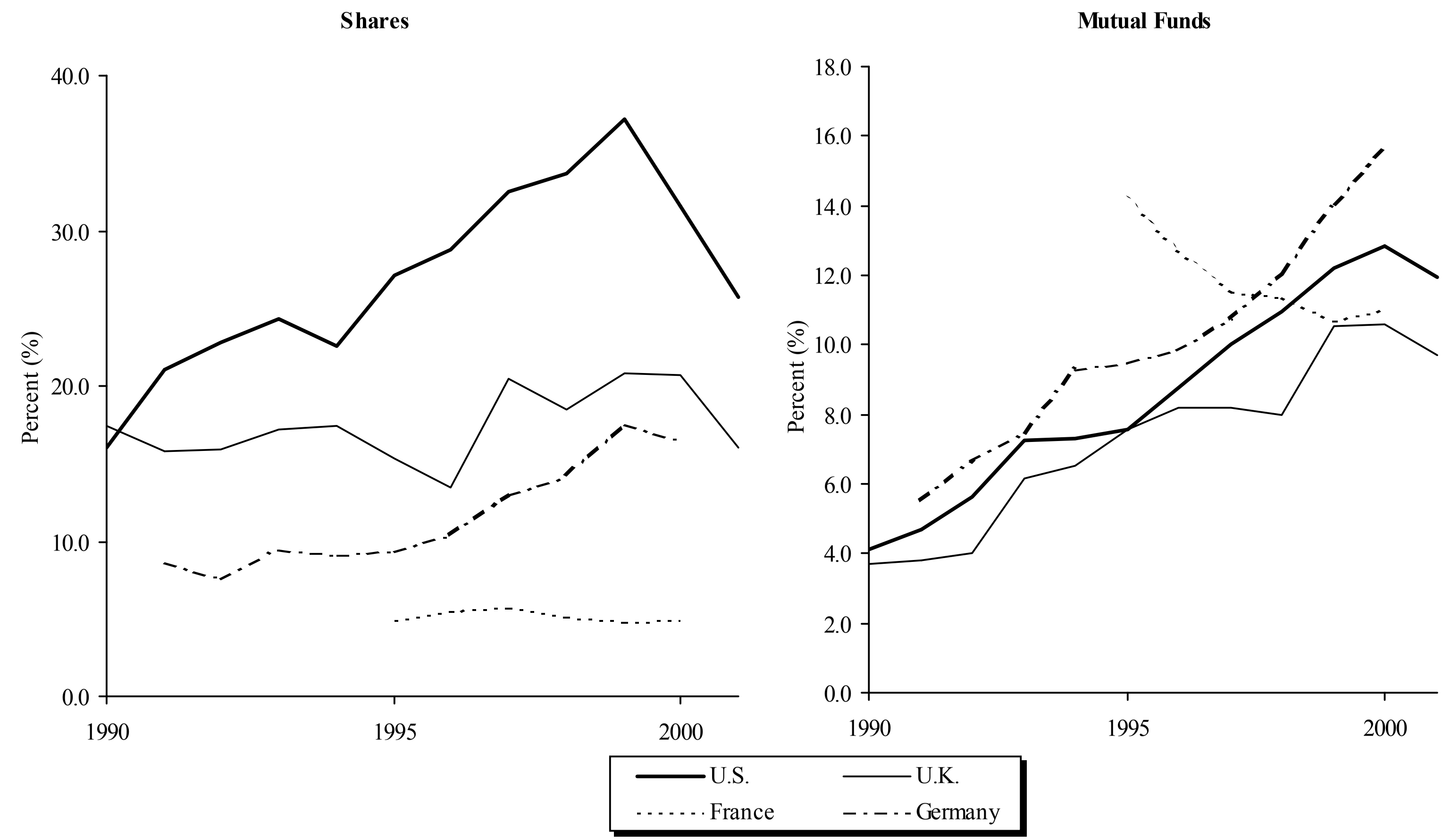
With equities relatively under-owned in Europe, Europe bulls have forcefully argued that ownership levels will continue to rise in the future. Morgan Stanley, for example, has forecast a "supercycle" for equities in Europe, anticipating new net demand for equities to grow $4.7 trillion between 2001 and 2010. Such bulls highlight several factors to support their case. First, of course, the bull market in the latter half of the 1990s increased general awareness and popular enthusiasm about owning equities, though confidence may be waning since 2000. Second, interest rates in Europe have fallen in recent years, as the fiscal straitjacket of the Maastricht criteria and the monetary discipline of the ECB have constrained Europe's politicians from inflationary pump priming. This has led investors to equities in search of higher returns than the bond and money markets now provide. Third, with its population rapidly aging, Europe is undergoing profound demographic change. By 2050, the ratio of elderly people to those of working age is projected to double. To prepare for retirement, workers are expected to increase their savings, at least a portion of which will be allocated to equities. Some countries are also shifting the responsibility of providing for retirement from the public sector to the private sector and individuals. Measures include lowering tax rates, deferring taxation on pension savings (though in several countries, private pension saving comes out of after-tax income), and introducing tax breaks to encourage savings. In addition, Germany, Sweden, and Denmark have encouraged pension funds to own equities by increasing the maximum allowed equity allocation, while Germany has allowed firms to buy back their shares. Fourth, partly in response to mounting demographic pressures and partly to broader economic forces, some European countries have adopted, or are considering adopting, legislation that encourages, directly or indirectly, households and institutional investors to hold equities. For example, privatizing government-run firms during the second half of the 1990s helped to boost the population's confidence in equities. However, demographic forces will not prove an unmitigated boon for equities. Pension reform may encourage people to increase their savings before retirement, but after exiting the work force, they will probably consume more and save less. Furthermore, progress on pension reform has been particularly slow in France and Spain.

Finally, in recent years Europe has seen a plethora of new financial products that have contributed to a rise in equity holdings. For example, an increasing number of life insurance companies are shifting from traditional defined benefit plans to unit-linked products, in which the policyholder's premiums are used to buy units in a fund operated by the insurer. Premiums of defined benefit plans are primarily invested in fixed income instruments, while those in unit-linked insurance policies are invested in a combination of fixed income and equities. Furthermore, online brokerage is growing rapidly, while the popularity of such products as futures, warrants, convertibles, and exchange-traded funds has surged among retail investors.

Continental European firms are still encumbered by excessive regulation, taxation, and labor market rigidity, and European governments have made no bones of their aversion to the "Anglo-American" form of capitalism in which they perceive stakeholders rights as sacrificed on the altar of shareholders' interests. Nevertheless, rhetoric notwithstanding (especially in election years), the Europeans also recognize the need to remove or mitigate the impediments to new business formation, since new businesses create the new jobs that politicians keep promising and failing to deliver. Moreover, at the center of the European Union, the Commission has fought valiantly against government bail-outs of national firms and sought to remove protectionist barriers to competition in many industries, including investment management. As we wrote several years ago in *Europe after EMU*, the evolution of a broader and deeper equity culture in Europe may be protracted, and sometimes appear to stall out or reverse course, but will gradually advance over time. This represents a tailwind (of varying strength) for European equities and informs our generally positive view of these markets for long-term investors.

Table A

HOUSEHOLD AND NONPROFIT EQUITY HOLDINGS AS A PERCENTAGE OF TOTAL FINANCIAL ASSETS ADJUSTED FOR PENSION AND LIFE ASSURANCE RESERVES



Sources: Banque de France, Datastream International, and Deutsche Bundesbank.

Notes: Shares represent direct or quoted shares owned by households and nonprofits. Pension fund and life assurance reserves have been subtracted from total financial assets in order to reveal those assets households and nonprofits have more control over. U.S. and U.K. data are as of 30 September 2001, while data for Germany and France are as of year-end 2000.

Table B

DISPARITY BETWEEN GDP AND EQUITY MARKET CAPITALIZATIONS

	% of World GDP	% of World Equity Market
Austria	0.8	0.1
Belgium	1.0	0.4
Finland	0.5	1.3
France	5.3	5.5
Germany	7.7	4.1
Greece	0.5	0.3
Ireland	0.4	0.3
Italy	4.4	2.2
Netherlands	1.5	2.7
Portugal	0.4	0.2
Spain	2.3	1.4
Total EMU (Luxembourg not included)	24.8	18.6
Switzerland	1.0	3.4
Denmark, Norway, and Sweden	2.2	1.9
U.K.	5.9	10.0
Japan	19.4	10.6
U.S.	40.9	50.4
Australia, Canada, Hong Kong, New Zealand, and Singapore	5.8	5.1
Total	100.0	100.0

Sources: Datastream International and *World Development Indicators* database. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Note: The World GDP and Equity Market defined by the MSCI World Index are as of December 31, 2000.