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European Fund and Asset Management Association
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THE EUROPEAN UNION MUST ADOPT A NEW DEAL TO MOBILIZE EU SAVINGS

INTRODUCTION

According to the European Commission, Europe needs to invest more than EUR 600 billion annually to achieve a successful green transition. Also, significant funds will be needed to support the digital transition. Creating the investment conditions necessary to meet these challenges is one of Europe's most urgent issues. Enrico Letta's report highlights the difficulty of this problem, noting that a substantial amount of EU savings is being 'diverted' to the American economy.

This paper underscores he acuity of this issue by demonstrating the increasing allocation of equity UCITS assets to US stocks and attributes this trend to the outperformance of US stock markets.

Table of Contents

- Introduction
- Growing European investment in the US
- Trends in the EU and US stock markets
- Asset managers and asset owners
- A New Deal for the European Union
- Conclusion

To unlock private investment to fund the EU's capital needs, it is crucial to leverage the potential of the Single Market and develop an effective Capital Markets Union (CMU) to offer more opportunities and better outcomes for Europe's companies and savers. Additionally, reorienting the European Commission's Retail Investment Strategy to encourage EU citizens to invest more in capital market instruments and promote retirement saving is imperative to increase the pool of savings available to support the EU's ambitions.

While achieving these strategic objectives is key, urgent action is also needed to fix the root causes of the EU economy's subdued growth outlook and enhance investment opportunities and returns. This requires a strategic reorientation of policies, particularly competition and industrial polices, to strengthen the EU economy's competitiveness and enable the emergence of Europe-based global champions.

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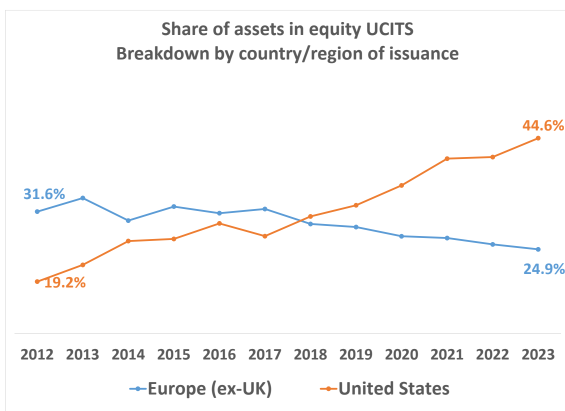
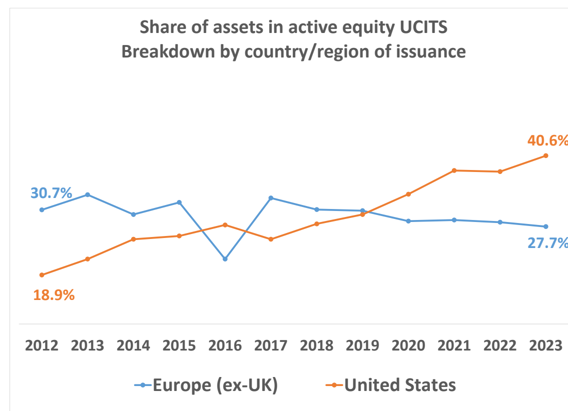
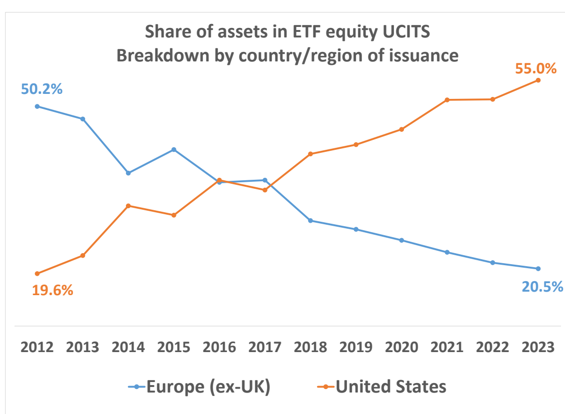
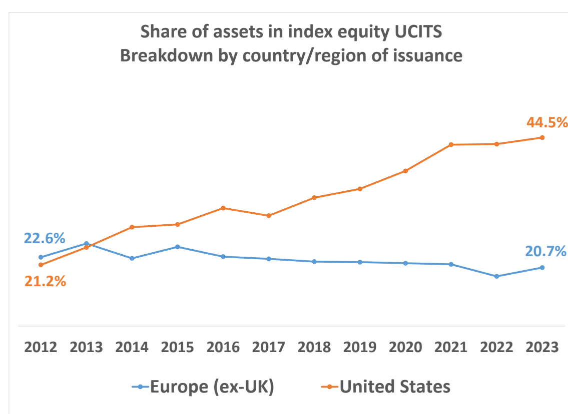
GROWING EUROPEAN INVESTMENT IN THE US

The charts below illustrate the evolution of the asset allocation of different types of equity UCITS (common vehicles for end-investors to get exposure to a broad range of listed assets in a range of global markets) since 2012. By the end of 2023, 44.6% of the portfolio of equity UCITS were invested in US assets, compared to 19.2% in 2012. Concurrently, the share of European (excluding UK) assets declined from 31.6% to 24.9%.









Source: EFAMA calculation based on Morningstar data

The growing investor appetite for exposure to US assets is particularly visible in exchange-traded fund (ETF) equity UCITS, with 34% of their total assets under management invested in funds that aim to replicate the performance of a specific US equity index, such as the S&P 500 or Nasdaq 100. In contrast, funds with a purely US investment focus made up only 13% of non-ETF equity UCITS assets.

The increased demand for UCITS with global investment focus also plays a role in explaining the shift from EU to US stocks, as the share of US stocks in the global equity market has increased over time. For instance, as of March 2024, US stocks constituted 62.6% of the MSCI All Country World Investable Market Index, compared to 12% for Europe excluding the UK.

Interestingly, the demand for global investment exposure played a more significant role in increasing the share of US assets in active equity UCITS than in ETF equity UCITS. By the end of 2023, global active equity UCITS, that allocate their assets primarily in stocks of companies located around the world, accounted for 41% of all active equity UCITS assets, compared to 23% for ETF equity UCITS assets.

The high exposure of equity funds to foreign assets is largely specific to Europe. In 2023, equity UCITS domiciled in the EU and the UK had 27% [i] and 29% [ii] of their portfolios invested in local stocks, respectively, whereas equity funds in the US and Asia-Pacific region allocated 78% and 84% to local companies' stocks.

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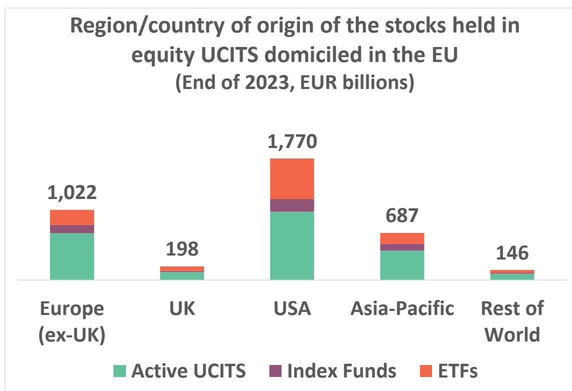
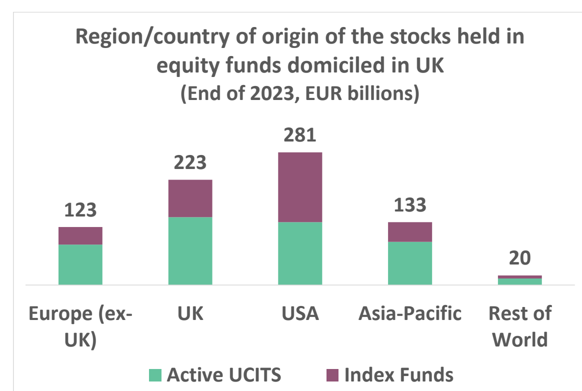
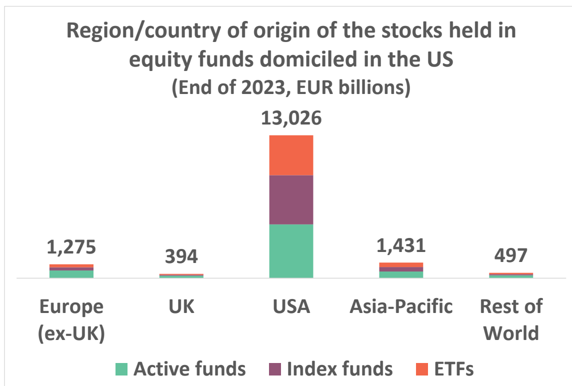
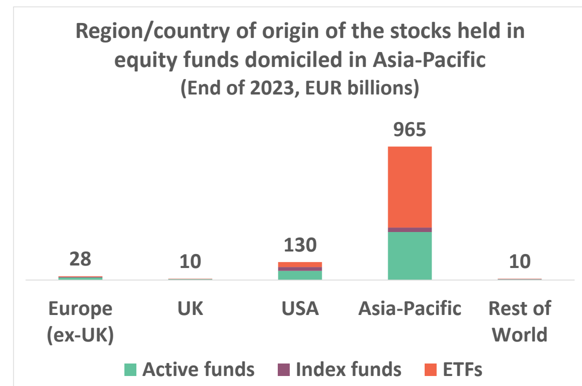








Source: EFAMA calculation based on Morningstar data

The differing investment behaviour between European and US investors can be attributed to several factors, including, *inter alia*:

- **Home bias**: Europe has a long history of international trade and cross-border investments. This tradition explains why EU investors often have a more global outlook and perceive benefits in diversifying their portfolios internationally. In contrast, the home bias of US investors can be explained by the importance of their financial system, the depth of their markets, the international dominance of the US dollar, and the perception that investing in US companies provides adequate diversification since many of these companies operate globally. Interestingly, at the end of 2023, US-based mutual equity funds held a larger total value of European stocks compared to equity UCITS.

- **Fund offerings**: Financial advisers may influence this trend by advising their clients to diversify their stock portfolios to gain exposure to a broader array of companies from different countries and regions to mitigate the risks associated with holding stocks from a single country. Also, thanks to the development of online fund platforms, which are expected to play a larger role in fund distribution in Europe over the next five years[iii], a growing number of retail investors can buy ETFs directly.

- **Market size**: While the EU has a sizable and mature stock market, it is not as large and liquid as the US stock market, partly due to the significant role of US pension savings, which are traditionally heavily invested in stocks in the United States.

- **Regulatory environment**: Differences in regulatory frameworks between the US and EU may also influence investor behaviour. For example, tax laws, retirement savings plans, and investment incentives can shape investors' preferences and decisions regarding asset allocation.

- **Technology and innovation**: The US is home to many leading technology and innovation companies, due to a combination of factors including access to a large pool of savings, significant venture capital and a culture that encourages innovation and risk-taking. EU investors may seek to capitalize on the growth potential of these companies by investing in US stocks.

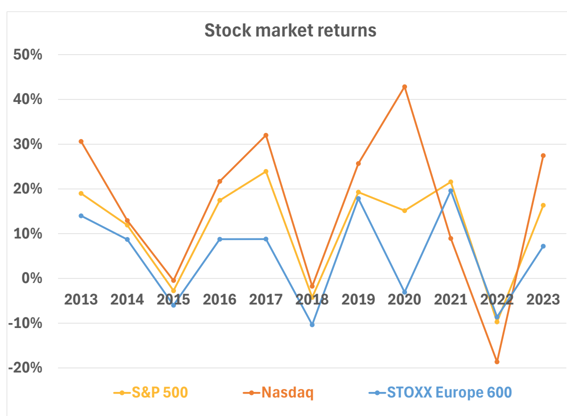
As far as Asian investors are concerned, their home bias may be caused by the following two distinct factors:

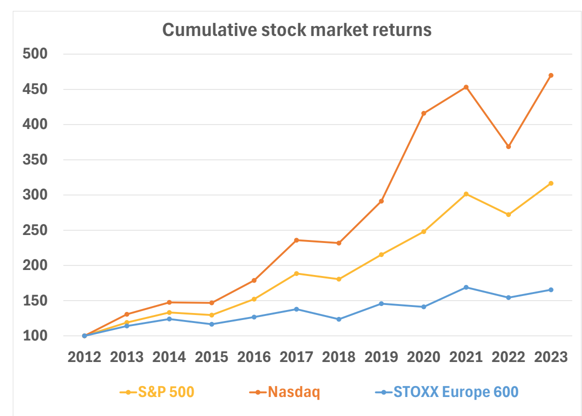
- **Economic growth prospects**: Many Asian economies have experienced rapid economic growth in recent decades. Hence, Asian investors may be optimistic about the growth potential of their domestic markets and prefer to allocate capital to companies positioned to benefit from domestic economic expansion.

- **Access to global markets**: Asian investors may still face barriers when investing in international markets due to regulatory restrictions, capital controls, currency risk, or lack of access to global brokerage platforms.

TRENDS IN THE EU AND US STOCK MARKETS

All these things considered, the growing investor appetite for US stocks can be attributed in large part to outperformance of US stock markets compared to Europe's in recent years, as illustrated in the charts below. Indeed, a Granger causality test reveals that the difference in stock returns between the S&P 500 and the STOXX Europe 600 significantly influences the disparity between the share of European and US assets in equity UCITS. A regression analysis confirms the robustness of the Granger-causality test. These results are presented in Annex 1.





Source: EFAMA calculation based on Yahoo Finance and MarketWatch data

The charts below indicate that factors such as population growth, spending in research and development (R&D) and fiscal stimuli have likely played a pivotal role in bolstering economic growth and stock market performance in the United States. Other contributing factors include, *inter alia*, lower energy prices.[iv]

Variations in economic growth performance among nations can be explained by disparities in the growth in labour and capital inputs, as well as variances in the efficiency of their use of these two resources, commonly referred to as total factor productivity (TFP). Among these factors, the contribution of labour to growth is hindered by the demographic pressure of an aging population on the global workforce.

According to IMF research, the median advanced economy experienced an average setback of about 0.9 percentage point in TFP growth due to declining allocative efficiency, resulting in a TFP growth rate of 0.5 percentage point during 2000-2019, as resources became more concentrated in relatively unproductive firms. However, the United

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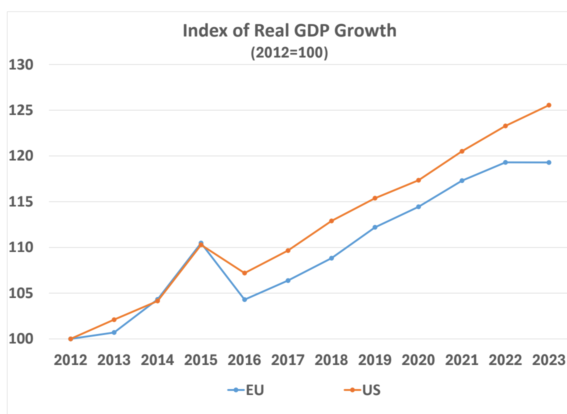
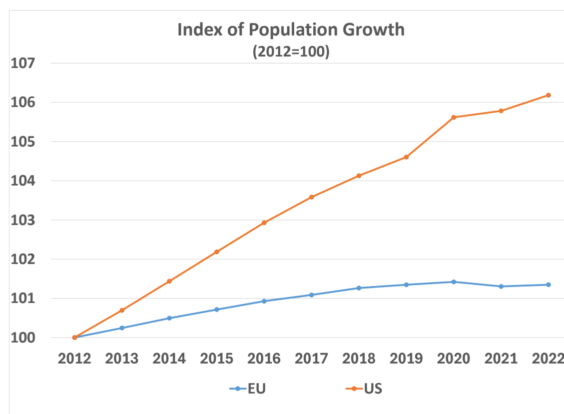
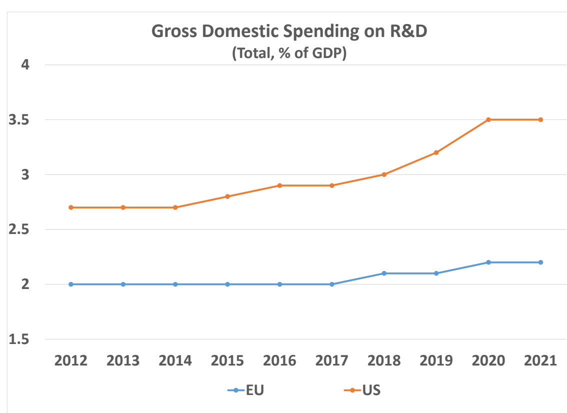
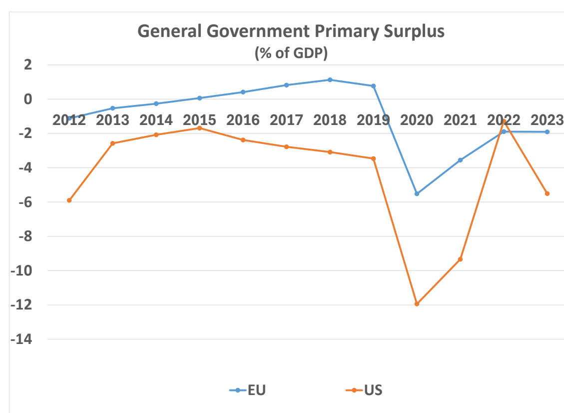
States stands out as an exception, where improvements in allocative efficiency contributed to an annual TFP growth increase of 0.8 percentage point during the same period.









Source: EFAMA calculation based on IMW WEO, OECD and World Bank data

Another study requested by the European Parliament's Committee on Economic and Monetary Affairs explains that the lower factor productivity growth in the European Union can be partly attributed to the slower adoption of information technology (IT) and lower levels of IT capital.

This study also shows that private R&D spending in the EU significantly trails that of the US, primarily due to the fewer number of large companies rather than a lower intensity of R&D. In the technology sector, encompassing both hardware and software, the greater R&D expenditure in the US can also be attributed to the larger scale of US companies. Obvious examples are the US mega tech companies. Europe has no firm among the top five R&D spenders in the global IT sector, whether in 'software and computer services' or 'technology, hardware, and equipment' categories, all of which are dominated by either US (four) or Chinese (one) companies.[v]

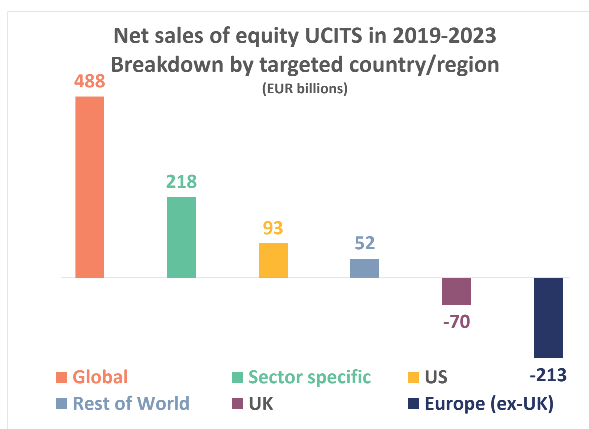
ASSET MANAGERS AND ASSET OWNERS

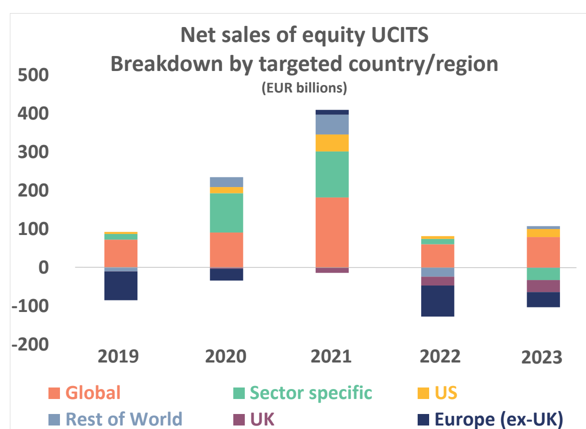
It is important to note that asset managers are agents acting on behalf of asset owners – the change in the geographical exposures of equity UCITS above all reflect the choices and preferences of asset owners, who use UCITS funds as vehicles to efficiently facilitate their asset allocation decisions.

Asset managers oversee an estimated EUR 30 trillion in assets across Europe for retail and institutional clients, the asset owners. They are pivotal in helping clients achieve their financial goals and serve as an important conduit for effective capital allocation, which is essential to the funding of the European economy. In this way, they support the transition to a more sustainable and digital economy while enhancing retirement resources in response to Europe's demographic changes. In carrying out their responsibilities, asset managers have the fiduciary duty to act in the best interest of asset owners, and to prioritize asset owners' investment outcomes and ensure good risk adjusted returns.

Asset owners set financial goals and clarify ESG preferences, taking into consideration factors such as asset class focus, risk tolerance, market conditions, economic projections, valuations, and investment costs. The superior performance of US stock markets has led many asset owners to increase their asset allocation to US stocks, particularly through investments in ETFs that track US indices like the S&P 500. More importantly, the increased globalization of the world economy has prompted many European asset owners to invest into global equity funds to diversify their stock investments internationally. As explained above, financial advisers may have played a role in driving this trend within the retail investor base in the European Union, advocating for their end-clients to allocate a larger share of their financial assets globally as a risk management strategy.

These trends are evident in the following charts, which show the evolution of net sales of equity UCITS from 2019 to 2023. These charts reveal that the cumulated net sales of global and US equity UCITS totaled EUR 488 billion and EUR 93 billion, respectively. In contrast, UCITS that primarily invest in Europe (ex-UK), including in a single European country, or target the UK saw net outflows totaling EUR 213 billion and EUR 70 billion, respectively. During the same period, sector specific UCITS, for which the geographical allocation of assets is not available, recorded EUR 218 billion of net inflows.





Source: EFAMA calculation based on Morningstar data

In order to attract capital to the local economy, a decisive shift in EU policies is required to enhance investment opportunities and increase returns. As soon as investors anticipate more promising return prospects in the EU, they will increase their investments in the region.

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A NEW DEAL FOR THE EUROPEAN UNION

It is encouraging to see significant momentum at the highest political levels to mobilize private capital to meet the EU's strategic needs. Notably, Enrico Letta's High-Level Report on the future of the Single Market and Christian Noyer's report on developing European capital markets to finance the future, following the Eurogroup's statement on the future of the Capital Markets Union (CMU), present important potential measures.

Indeed, in today's fiercely competitive global landscape, the **Single Market** stands as a cornerstone of the EU economy, offering European companies access to significant scale and a platform for global expansion. However, its functioning should be improved to bolster EU competitiveness, ensuring access to the capital and technologies necessary to address the twin transitions.

Building an effective **Capital Markets Union** is equally vital because European capital markets are losing their competitiveness, particularly when compared to the United States. This poses a risk to Europe's progress, as capital markets are essential for financing innovation and generating the returns needed to support an ageing population. A fragmented regulatory environment hampers market efficiency and leads an increasing number of European companies to publicly list overseas, attracted by better listing conditions, higher valuations, and larger capital pools. ESMA's recent Position Paper on "Building more effective and attractive capital markets in the EU" also stresses that the fragmentation of the EU's capital market landscape has an impact in terms of inefficiencies and higher costs. Demand-side measures are necessary to direct more savings towards European capital markets, which must be continuously improved and modernized to keep pace with evolving expectations and technology. A recent report, co-developed by EFAMA, the European Banking Federation (EBF) and the Federation of European Securities Exchanges (FESE) and authored by Oliver Wyman, sheds light on progress made towards the CMU and presents recommendations for success in the coming decade and beyond.

Nevertheless, solely focusing on the Single Market and the CMU will not be enough to substantially enhance investor returns and increase the volume of investments needed to finance the twin transitions. To achieve that goal, it is also necessary to strengthen the competitiveness of the EU economy and its firms, including the European financial sector. Greater competitiveness will drive up firms' revenues, expand their market share, and boost their profitability, all of which are essential for improved financial performance and, consequently, higher company valuations. This will result, all else being equal, in an increase of the share of EU stocks in global indices , even if investor preference for global equity funds was to remain unchanged.

In this context, President Ursula von der Leyen's decision to commission Mario Draghi to prepare a report on the future of European competitiveness, with proposals to reinvigorate the EU's economy amidst stiff competition from China and the United States, is highly commendable. In our view, this report should propose measures in four key areas:

- **Industrial and competition polices**. These policies should be reoriented to accelerate activities conducive to EU development, attract private investors to engage in new business partnerships, address strategic dependencies, strengthen strategic autonomy, combat foreign distortive industrial subsidies, and ensure that EU competition rules are fit-for-purpose and align with recent technological and market developments to fully support the green and digital transitions.

- **Energy prices**. Initiatives are required to mitigate the existing energy price differentials between the EU and the US, which adversely affect the EU's attractiveness for investments and the competitiveness of EU companies. Measures to enhance energy efficiency are particularly crucial for industries vulnerable to competition outside the EU, in particular manufacturers of basic metals, glass, textiles, and basic chemicals.[vi]

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- **Fiscal policy**. Substantial public financial support will also be indispensable for facilitating the green transition.[vii] The United States has recognized this necessity, as evidenced by the adoption of the Inflation Reduction Act (IRA) in 2022. This comprehensive 10-year plan includes an estimated $780 billion in tax subsidies for production and investment, aimed at meeting US climate goals, strengthening energy security, investing in America, reducing energy and health care costs for families, and making the tax code fairer. Learning from this, the EU should streamline procedures for granting aid, focusing on sectors with significant environmental and technological externalities where EU countries possess comparative advantages.

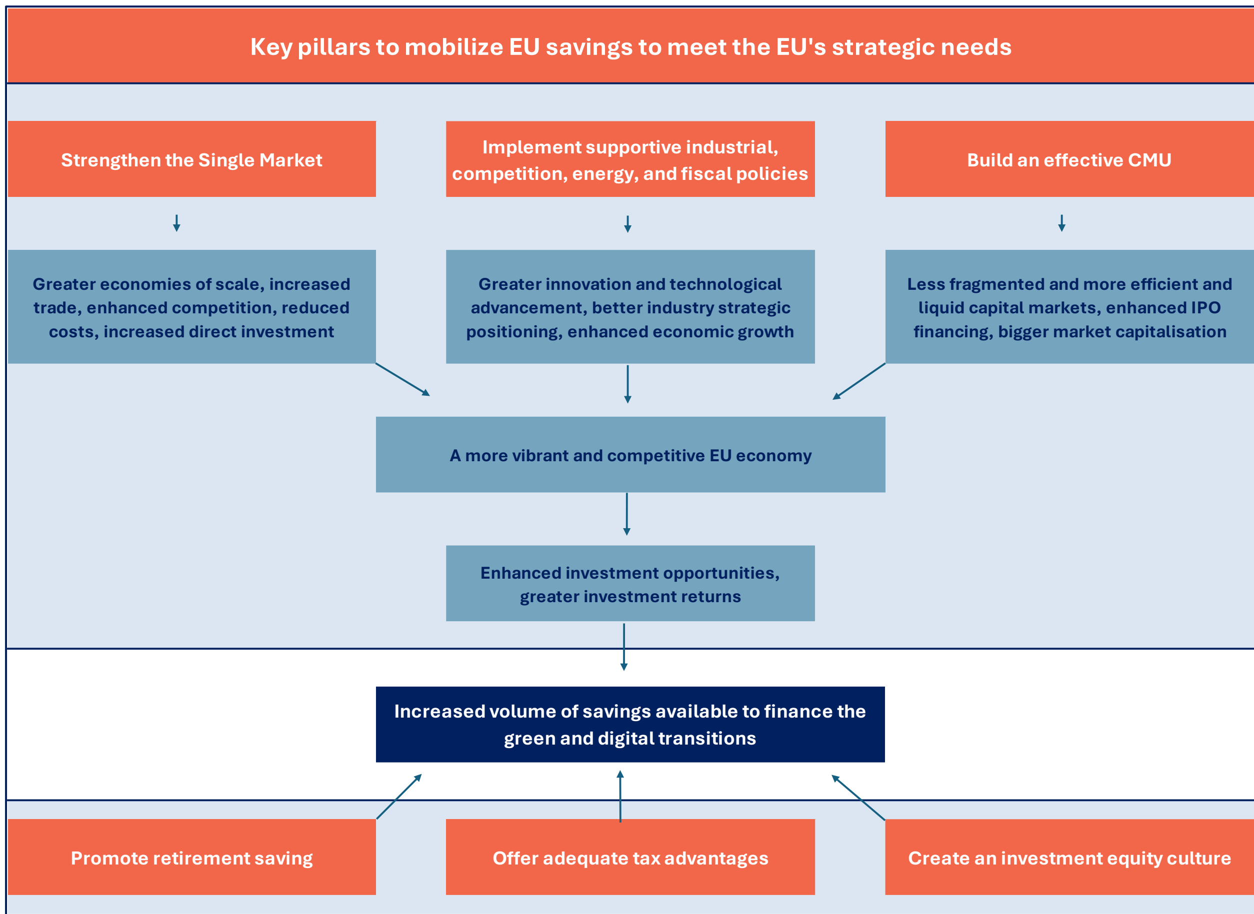
  In a recent study, the IMF also contended that a well-designed fiscal policy geared towards promoting innovation can substantially enhance productivity, increase GDP, and lower debt-to-GDP ratios in the long run. This strategy ought to encompass public investment in fundamental research, grants for innovative start-ups, tax incentives to spur applied innovation across firms, and supportive structural, competition, trade, and financial policies to establish a level playing field, avoid concentration of market power, and ensure adequate funding access throughout the innovation cycle, particularly for long-horizon green energy projects.[viii]

- **Asset management**. The competitiveness of European asset managers is critical for the financing of the economy, mobilizing more savings to finance the green and digital transitions. Their proximity to European enterprises, including SMEs, and their comprehension of local dynamics, political landscapes, and economic contexts, enable them to adopt a proactive stance in funding domestic projects. This will include leveraging the ELTIF 2.0 regime to invest in non-listed or less liquid assets. To be competitive, European asset managers need an enabling regulatory framework and stricter adherence to the principles of 'Better Regulation' and proportionality. A report recently published by EFAMA, entitled '*Unlocking private investment to fund Europe's triple transitions – Towards an enabling regulatory framework*', makes concrete recommendations on how to create such an enabling regulatory framework.

Finally, the **Retail Investment Strategy** should be reoriented to encourage EU savers to invest more in capital markets. Currently, they hold a disproportionate amount of their savings in cash and bank deposits, and they continue to increase these holdings by a large amount every year. Between 2015, when the European Commission launched the CMU, and 2023, EU households increased their holdings of cash and bank deposits from EUR 8 trillion to EUR 11.6 trillion, or from 40.3% of their financial wealth to 42.1%.[ix]

To encourage households to save more in capital market instruments requires fostering an investment equity culture, emphasizing the potential net return of long-term investing, with a broader focus beyond just costs.[x] Voluntary public policy measures are also needed to promote retirement savings, particularly by offering adequate tax incentives. Tax incentive policies may also be considered to help direct EU savings towards EU investment needs, as currently exists in some jurisdictions.

The flow chart below outlines what is needed to mobilize EU savings to meet the EU's strategic needs. This requires unlocking the potential of the Single Market, creating an effective Capital Markets Union, strengthening the competitiveness of the EU economy and its firms, and reorienting the Retail Investment Strategy.



CONCLUSION

To compete effectively on the global stage and foster the emergence of Europe-based industry leaders, the EU must embark on a transformative journey to boost its economic growth, enhance investment opportunities, generate higher investment returns, and increase the market capitalization of European companies. These are necessary conditions to attract more investment capital to the EU and ensure European companies access financing throughout their development.

This, in turn, can initiate a virtuous circle wherein increased economic growth reinforces the confidence of asset owners in the EU economy, thereby strengthening the capacity of asset managers to provide a critical source of stable, long-term funding to European governments, companies and infrastructure projects.

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Annex 1: Results of the Econometric Analysis[1]

We used the Granger causality test[2] to test whether the difference between the share of European and US assets in equity UCITS may be caused by the difference in returns between US and EU stocks. We estimate the following relationship between the two variables using monthly data during the period 31/04/2013-31/12/2023[3]:

$$DShare_differential_t = \sum_{i=1}^{m} \alpha_i DShare_differential_{t-i} + \sum_{j=1}^{m} \beta_j \, lnReturn_differential_{t-j} + \varepsilon_t$$

$$lnReturn_differential_t = \sum_{k=1}^{m} \gamma_k lnReturn_differential_{t-k} + \sum_{l=1}^{m} \delta_l \, DShare_differential_{t-l} + \eta_t$$

where:

- $Share_differential$ is the variable corresponding to the difference in shares of US and European assets in equity UCITS. The variable is differenced (*D*) to obtain a stationary series.

- $Return_differential$ is the variable corresponding to the difference in returns between the S&P 500 and the STOXX Europe 600 indices, approximating the difference in the US and European stock returns. We take the logarithmic transformation of the series to account for stationarity.

The table below presents the results of the Granger causality test with 2-lags, revealing that the null hypothesis that the stock market return difference (Return_differential) does not *Granger-cause* the difference between the share of US and European assets (Share_differential) is rejected. This rejection signifies that **the difference in returns between the S&P 500 and the Stoxx Europe 600 is significantly useful in predicting the difference between the shares of US and European assets in equity UCITS.** Conversely, the reverse proposition does not hold true.[4]

Table I. Granger causality test statistics for the US-Europe share differential in equity UCITS and returns differential during the period 31/04/2013-31/12/2023

Null hypothesis (H_0)	No. of observations	F-statistics	P-value
Return_differential does not Granger cause Share_differential	130	7.71	0.00
Share_differential does not Granger cause Return_differential	130	0.15	0.86

The results remain robust when the same test is repeated at higher-level lags.

[1] This econometric analysis has been performed by Vera Jotanovic, Senior Economist, EFAMA.
[2] The Granger causality test is a statistical hypothesis test for determining whether one time series is useful in forecasting another. A time series *X* is said to Granger-cause *Y* if it can be shown that *X* values provide statistically significant information about future values of *Y*.
[3] The data on UCITS allocation are obtained from Morningstar Direct, while the data series for equity returns are obtained from Yahoo Finance.
[4] The F-test cannot reject the null hypothesis that the difference between the shares of European and US assets in equity UCITS has no power in explaining stock market returns difference.

We further estimated a time series regression equation to understand the time lag at which the difference in stock returns helps predict the difference in UCITS allocation towards US versus European stocks.

$$DShare_differential_t = \beta_0 + \sum_{j=1}^{m} \beta_j \, lnReturn_differential_{t-j} + \varepsilon_t$$

Regression results confirm the robustness of the Granger-causality test, indicating that stock market return differential ($Return_differential$) helps predict and causes the allocation of European and US assets in equity UCITS with 1% significance at one-month lag. We tested different maximum lag levels (m), finding consistent results. For example, the results for the 3-lag specification of the equation (m=3) is reported below:

Table II. Regression equation estimation results for the UCITS allocation share differential and return differential during the period 31/04/2013-31/12/2023

Dependent variable: UCITS shares differential (130 observations)	
Regressor	P-value
Constant	0.09*
Returns differential	0.12
Returns differential (1-month lag)	1.9e-4***
Returns differential (2-months lag)	0.19
Returns differential (3-months lag)	0.52

THE VOICE OF THE EUROPEAN INVESTMENT MANAGEMENT INDUSTRY

EFAMA is the voice of the European investment management industry, which manages around EUR 30 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors.

Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities.

EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book.

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ENDNOTES

[i] *This percentage corresponds to the value of the European stocks held by equity UCITS domiciled in Europe (ex UK), i.e. EUR 1,022 bn, compared to the total net assets of equity UCITS covered in Morningstar Direct at the end of 2023, i.e. EUR 3,824 bn.*

[ii] *An interesting aspect of the equity fund market in the UK is that ETFs bought and sold by a UK investor are most of the time domiciled outside of the UK, typically in Ireland or Luxembourg. This is the reason why the Morningstar database (Morningstar Direct) does not include ETF equity funds domiciled in the UK.*

[iii] *This is one of the findings highlighted in a recent EFAMA publication, entitled 'Investment Fund Distribution Channels in Europe'.*

[iv] *By way of illustration, the price of electricity and gas per kilowatt hour averaged $0.31 and $0.16 in France, Germany and Italy in 2022, compared to $0.16 and $0.05 in the US (source: Visual Capitalist).*

[v] *Source: 'Coordination for EU competitiveness', a report written by D. Pinkus, J Pisani-Ferry, S. Tagliapietra, R. Veugelers, G. Zachmann, and J. Zettelmeyer.*

[vi] *See analysis by Bialek et al. 2023.*

[vii] *See joint statement of members and staff from the German Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung and from the French Conseil d'Analyse Economique.*

[viii] *Source: Chapter 2 in IMF Fiscal Monitor published in April 2024, entitled 'Expanding frontiers: fiscal policies for innovation and technology diffusion'.*

[ix] *Derivatives, loans, unlisted shares, and non-life insurance are excluded from households' financial wealth in the calculation of these ratios, as these assets are managed based on different criteria than those that determine how households allocate their savings between the main types of financial instruments, i.e., cash and deposits, pension plans in the form of funded pensions, life insurance products, investment funds, debt securities, and listed shares.*

[x] *Another EFAMA report, entitled 'Household participation in capital markets – assessing progress focusing on 2020-2022', includes recommendations to boost access to funded occupational and personal pensions and ensure that the Retail Investment Strategy will not discourage retail investors from investing in capital market instruments.*