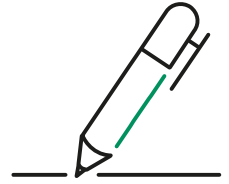


RESEARCH PAPER



IS QUALITY OUT OF FASHION IN EUROPEAN EQUITY MARKETS?

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October 2025



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INTRODUCTION

Both [academic studies](#) and practitioners have shown that ‘Quality’ stocks, across regions, have provided higher returns compared to their benchmarks.

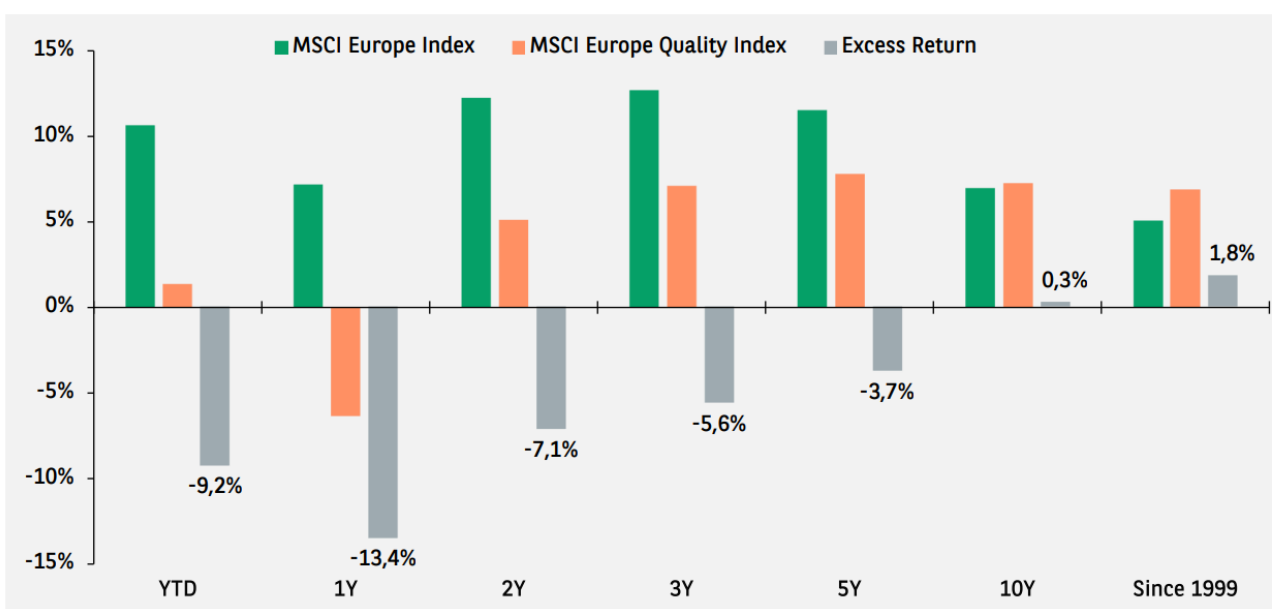
[Definitions may differ among practitioners and academics](#) but, in general, Quality stocks are characterised by strong balance sheets, conservative debt levels and relatively high returns on equity.

Over the long run, we see that Quality stocks (proxied by the MSCI Europe Quality Index, and which I will refer to as ‘Quality’) have outperformed the MSCI Europe Index (which I will refer to as the ‘Benchmark’), on average, by 1.8% per year (Exhibit 1) since 1999.

Exhibit 1

In the long run (since 1999) European quality stocks have outperformed their benchmark

(annualised net total returns for the MSCI Europe and MSCI Europe Quality indices; in euro terms)



Data from December 1999 to August 2025. Data corresponding to periods shorter than one year is not annualised. Source: MSCI Europe, BNP Paribas Asset Management.

However, as Exhibit 1 shows, over the last five years, the excess return of ‘Quality’ over the ‘Benchmark’ has been significantly negative.

For example, for the year to 29 August 2025, ‘Quality’ underperformed the ‘Benchmark’ by 13.4%. Although factors and styles may underperform in certain cycles, this relatively large drawdown caught investors off guard.

In this paper I provide an analysis of why Quality stocks underperformed, and the steps investors can take to ensure their portfolios take full advantage of the 'Quality' factor in portfolios.

WHY HAS QUALITY UNDERPERFORMED IN THE RECENT PAST?

When we look closer at performance attribution for the 12 months through August 2025 (Exhibit 2), we notice that the negative excess return is due to a combination of poor sector allocation (-5.4%) and security selection (-8.1%).

Interestingly, the sector allocation effect is essentially due to the two largest sector allocations that are implemented in the 'Quality' index: namely, a large overweight in healthcare and an underweight in financials.

The security selection effect of the index's composition is highly negative in both those sectors, as well as in the Industrials, IT and Consumer discretionary sectors.

In fact, security selection is negative across all sectors.

Exhibit 2

Sector allocation made a significant negative contribution to returns of the unconstrained 'Quality' index (August 2024 to August 2025)

	Weights (%)			Performance attribution			
	Quality	Benchmark	Difference	Sector allocation (%)		Security selection (%)	
Total	100,0	100,0	0,0	-5,4		-8,1	
Communication services	2,0	4,2	-2,2	-0,2		-0,3	
Consumer discretionary	11,6	8,0	3,6	-0,6		-0,6	
Consumer staples	17,1	9,9	7,2	-0,4		-0,2	
Energy	0,0	4,4	-4,4	0,3		-0,1	
Financials	10,5	23,6	-13,1	-2,8		-1,7	
Healthcare	23,9	13,6	10,4	-2,1		-0,9	
Industrials	21,9	19,2	2,8	0,6		-2,8	
Information technology	7,6	6,7	0,9	-0,1		-1,0	
Materials	5,0	5,5	-0,4	0,2		-0,3	
Real estate	0,0	0,8	-0,8	0,1		0,0	
Utilities	0,3	4,3	-4,0	-0,2		0,0	

Data from August 2024 and August 2025. Source: MSCI Europe, BNP Paribas Asset Management.

The large active sector allocations within the Quality index are simply the result of how individual securities are scored. This scoring carries significant sector-based biases.

To see how the active sector weightings relate to classic quality measures, we plot, on the x-axis, in Exhibit 3 the relationship between:

- (a) The difference in each sector’s return-on-equity (ROE) relative to the benchmark
- (b) Each sector’s debt/equity ratio relative to the benchmark

The Quality sector’s active weights are shown on the y-axis.

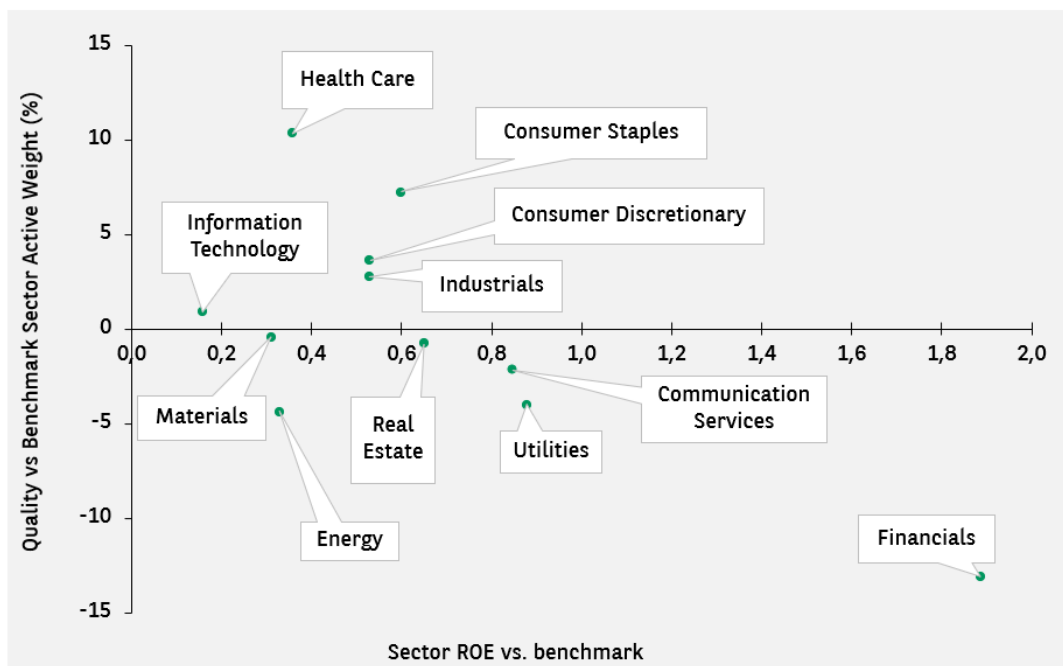
Healthcare looks attractive on both metrics: It has a higher ROE than the Benchmark (a 4% difference: 16% vs. 12%) as well as a lower debt/equity (a ratio of 0.4 versus the Benchmark).

Financials look attractive on ROE but they are an outlier on the debt/equity ratio, where they carry a ratio of 1.8 versus the Benchmark (i.e., a debt/equity ratio almost twice that of the Benchmark).

Exhibit 3

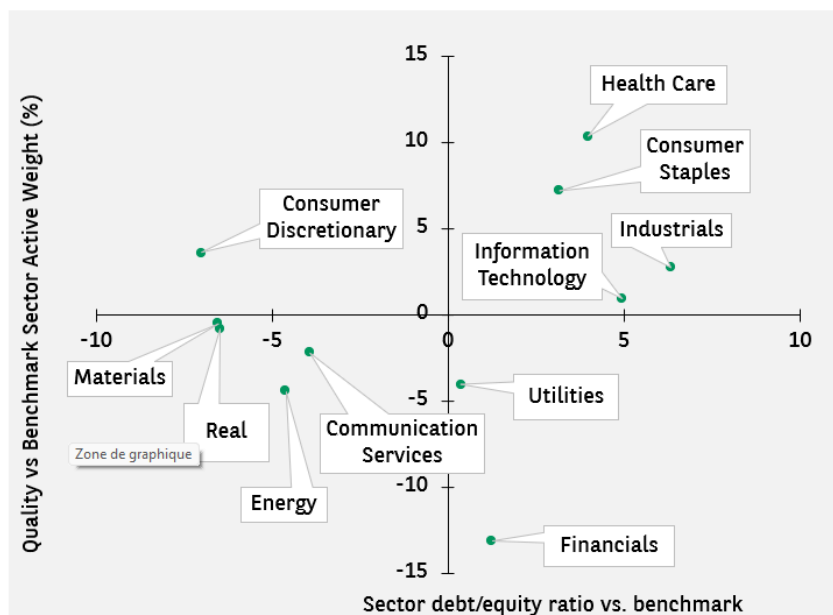
Assessing active sector weightings in the ‘Quality’ index relative to the classic characteristics of Quality

a. Sector return on equity in excess of the benchmark’s ROE against the active weight of Quality versus the benchmark



Data as of 29 August 2025. Source: MSCI Europe, BNP Paribas Asset Management.

b. Sector debt/equity ratio relative to the benchmark's debt/equity ratio for the active weightings of 'Quality' versus 'Benchmark'



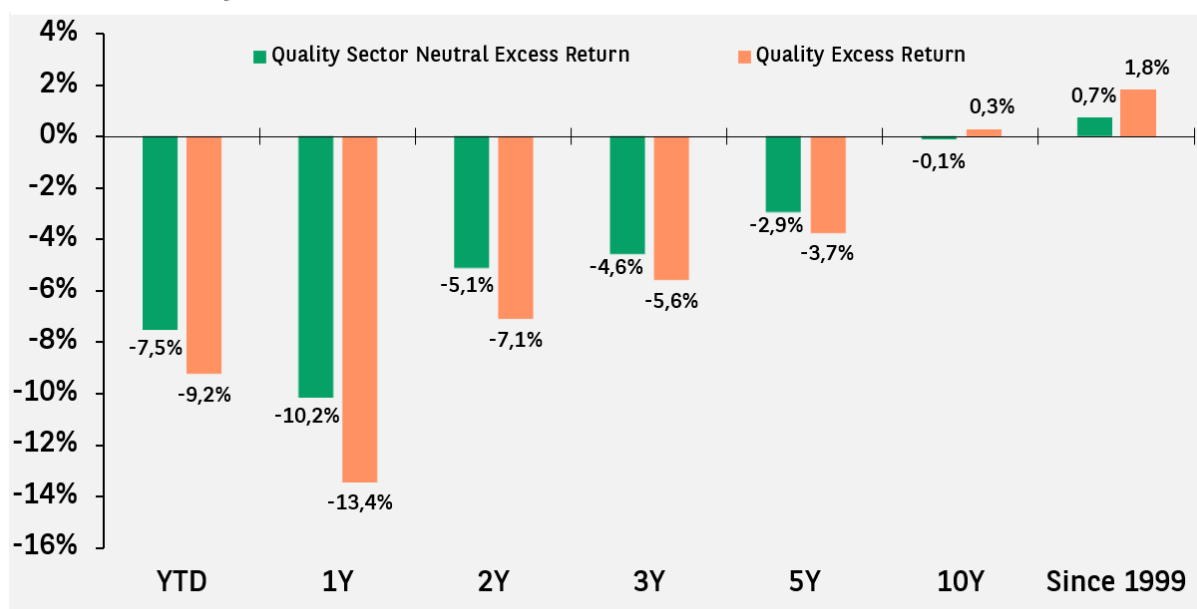
Data as of 29 August 2025. Source: MSCI Europe, BNP Paribas Asset Management.

Clearly it makes sense to build and consider a 'Quality' factor that takes into account, among other things, sector biases, since they may drive large active allocations which, at times, can be costly.

For example, in Exhibit 4, we compute the equivalent of Exhibit 1 for both the 'Quality' index and its sector-neutral version. Although over the long term, we see the unconstrained 'Quality' version delivers slightly higher returns (1.8% versus 1.2%), returns over the last five years are clearly in favour of the sector-neutral version.

Exhibit 4

Since 1999, a Quality sector-neutral index has delivered better returns than its unconstrained peer (annualised excess returns in euro terms)



Data from December 1999 to August 2025. Data corresponding to periods shorter than one year is not annualised.
Source: MSCI Europe, BNP Paribas Asset Management.

For instance, over the year ending on 29 August 2025, the excess return of Quality was -13.4% versus -10.2% for the sector-neutral index.

Both sets of returns are of course sufficiently large (and negative) to make them unappealing, but they show how portfolio construction and factor investing can be improved by neutralising structural biases that appear naturally in financial ratios.

In Exhibit 5 we show the top and bottom contributors to the total excess return in the year to 29 August 2025.

Exhibit 5

Top and worst performance contributors to the excess return of 'Quality' versus 'Benchmark' (for the year ending 29 August 2025)

Company	Active weight (%)	Active contribution (%)
Top contributors		
Rheinmetall	0,63	0,56
Sanofi	-1,03	0,23
Totalenergies	-1,14	0,21
Imperial Brands	0,49	0,16
Zurich Insurance	1,06	0,15
Glencore	-0,39	0,14
DSV	-0,21	0,14
Stellantis	-0,21	0,13
Allianz	0,86	0,13
Adidas	-0,35	0,13
Bottom contributors		
Siemens	-1,48	-0,42
Astrazeneca	3,11	-0,47
Rolls-royce Holdings	-0,69	-0,50
Banco Santander	-0,85	-0,50
HSBC Holdings	-1,67	-0,54
Roche	3,13	-0,54
ASML Holding	2,36	-0,58
Nestlé	2,71	-0,60
LVMH	1,94	-0,70
Novo Nordisk	1,66	-1,68

Data as of 29 August, 2025. Source: MSCI Europe, BNP Paribas Asset Management.

Interestingly, among the best contributors to Quality performance, we see few active overweights: most of the positive contribution came from underweighting companies that underperformed over the period.

At the same time, among the lowest contributions we see large active positions, which is consistent with the large and negative selection effect (Exhibit 2).

Indeed, apart from a few names where the contribution was positive, the overall effect is dwarfed by both the large overweight of the healthcare sector (which significantly underperformed the Benchmark, by ~23%), as well as a number of large single-stock allocations that turned out to be very costly (Novo-Nordisk, for example).

In the financials sector, among the other large sector allocations for the Quality factor, we notice that, on average, financial companies do not rank well on quality measures (hence the

underweight), and among financials, quality measures tend to favour insurance companies over banks. While both did well over the same period (+20% for European insurance companies and +47% for banks versus the Benchmark), the preference for the former over the latter has also been a net negative contributor.

PERSPECTIVES

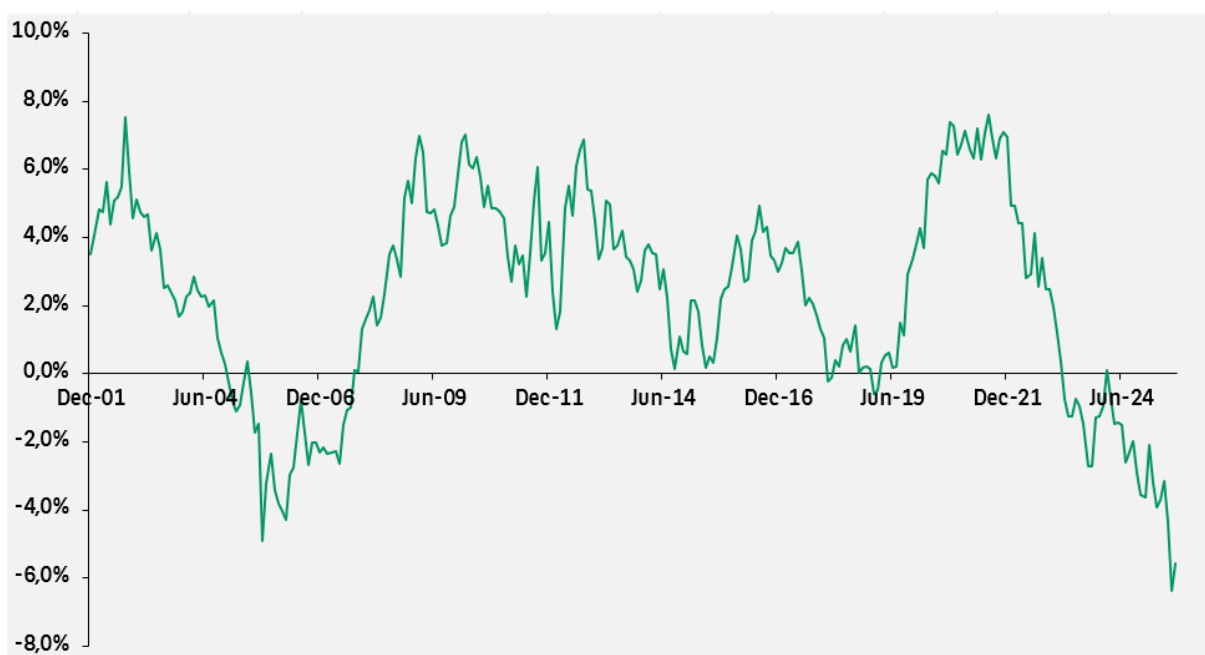
The last few years have been a tough environment for the Quality factor in European equities.

If we look at the three-year rolling excess return of Quality versus the Benchmark (Exhibit 6), we are today at the lowest level in the last 25 years.

Exhibit 6

The 3-year rolling excess returns of the Quality factor in European equities versus the benchmark are at the lowest level in 25 years

(3-year annualised rolling excess returns of the 'Quality' factor versus those of the 'Benchmark')



Data as of 29 August, 2025. Source: MSCI Europe, BNP Paribas Asset Management.

The last time the rolling excess return reached today's low was in 2006 and 2007, just prior to the Great Financial Crisis. Moreover, the chart highlights the cyclical nature of the 'Quality' factor's excess returns.

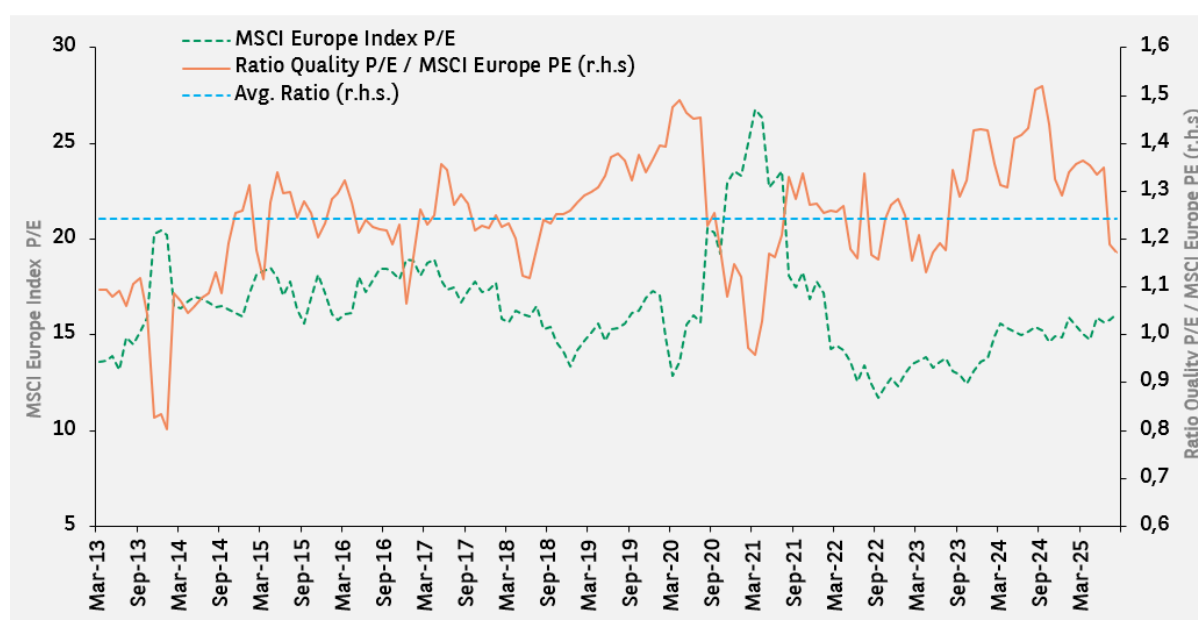
The fact that a 25-year low has been reached does not necessarily mean that a comeback in the next few months is the most likely scenario. But it shows that when such a performance drawdown occurred in the past, it was followed by a strong recovery that gave rise to a positive three-year excess return for most of the following 15 years, until 2022.

Furthermore, if we look at the current valuation of the ‘Quality’ factor, we do not see signs of excesses that should be corrected.

Based on the general definition of ‘Quality’, we may expect it to carry a higher price-earnings (P/E) ratio than the market. And indeed, the long-term P/E ratio of ‘Quality’ is at a multiple of 1.24 relative to that of the ‘Benchmark’ (see Exhibit 7).

Exhibit 7

As might be expected, the price/earnings ratio of the ‘Quality’ index is consistently higher than the P/E of the MSCI Europe index



Data as of 29 August, 2025. Source: MSCI Europe, BNP Paribas Asset Management.

Today’s P/E ratio for ‘Quality’ is at 1.17 relative to the ‘Benchmark’, down from 1.5 as of August 2024. So, it is fair to say that from a valuation perspective, ‘Quality’ was trading higher than its historical average, peaking in August 2024. It has largely corrected since then.

Interestingly, since 2013, large falls in the valuation of ‘Quality’ have coincided with increases in the market’s overall P/E ratio: This occurred both in 2014 and in the aftermath of the Covid crisis. Today, we see a gradual rise in European valuations from the bottom - the P/E ratio reached 11.6 in September 2022 before rising to 16 in August 2025.

CONCLUSION

As we have shown, portfolio construction is important in mitigating the shortcomings of 'Quality' (or any other investment style factor, such as Value, Momentum, Growth or Low Risk). Managing structural biases can improve short-term resilience (as we have seen this year with Quality).

Diversifying the measures and the signals to define one's own Quality factor has beneficial effects in the overall portfolio exposure as it reduces the risk of outliers and therefore unwanted idiosyncratic effects. We have also seen how significant active weightings even in large, well-established and well-known names can have negative effects on performance.

As always, risk management is a key part of the process and should not be compromised, even for companies that fulfil the definition (at least from a quantitative point of view) of Quality.

Finally, without a clear trigger effect, investors may be better off by combining quality exposure, which we believe works over the medium to long term, with other styles that can help dampen short-term negative effects.

Multi-factor strategies, for example, can offer exposure to Quality (and other well-known investment styles) while, at the same time, capitalising on its low correlation with styles such as Momentum, Low Risk or Value.

The renowned 20th century mathematician, Nobert Wiener, a pioneer in, among other things, cybernetics and stochastic calculus, once said the "[...] the best model for a cat is another cat, or preferably the same cat...". However good the concept behind investing in Quality, portfolio construction, risk management and efficient implementation remain key ingredients for success.



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Carmine joined BNPP AM in July 2024 from Ossiam where he spent 12 years, first as Portfolio Manager and then as Head of Research and ESG.

He has extensive experience in systematic and responsible investment solutions. His recent research topics have focused on sustainability, applications of machine learning and artificial intelligence in finance, Bayesian learning and portfolio construction under uncertainty.

Carmine holds a PhD in Probability and Finance from Université Denis Diderot – Paris VII.

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