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Investing for a world of change

The growing appeal of international allocations: alpha, rotation, and valuation

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The fast view

International equities can offer:

- **Rich alpha:** The majority of outperforming shares globally over the past decade have been international, providing a highly diverse opportunity set.
- **Rotational opportunity:** Historical performance cycles between US and international markets suggest potential for leadership change.
- **Valuation advantages:** International equity benchmark valuations are lower than US, even accommodating for compositional differences.
- However, international market **fundamentals are weaker**; a blunt, benchmark-level reallocation could be detrimental to portfolio returns.
- We believe a **focused**, **active**, and **quality-oriented** approach is well-placed to capture international opportunities without compromising key return drivers.

For further information on the investment team, please see the Important information section.

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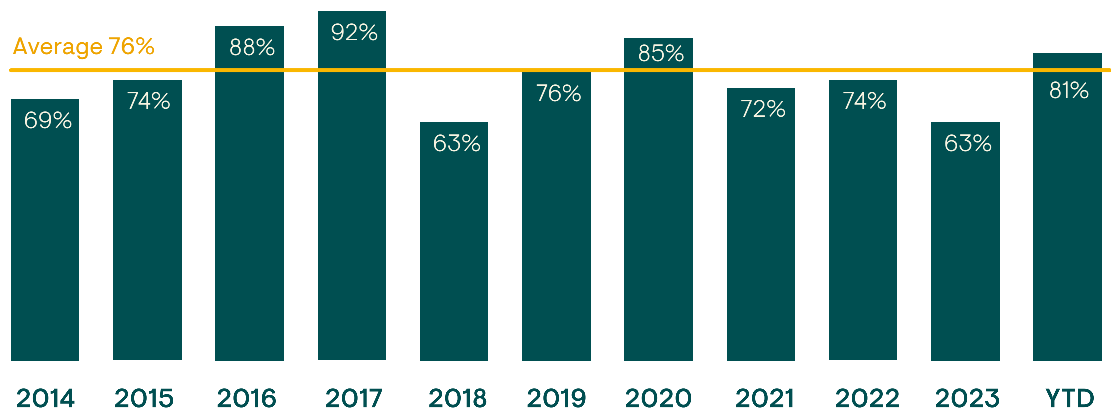
A rich source of alpha

As we approach the final stretch of another year dominated by US equities, a surprising fact emerges; international shares comprise the majority of global outperformers. Examining the top 100 annual performers of the ~2,750-member MSCI All Country World Index over the past decade, more than three-quarters hail from outside the US, with 2024 no exception. This rich and highly diverse opportunity is missed by many investors focused solely upon benchmark-level performance.

Figure 1: International equities account for a significant portion of outperformers

% of top 100 stocks that are non-US



Source: Factset, MSCI ACWI, Ninety One, as of June 30, 2024. The top 100 performers were assessed over the past 10 years. The MSCI ACWI captures large and mid-cap representation across 23 developed markets (DM) and 24 emerging markets (EM) countries, with an average market cap of US$27 billion. For further information on indices, please see the Important information section.

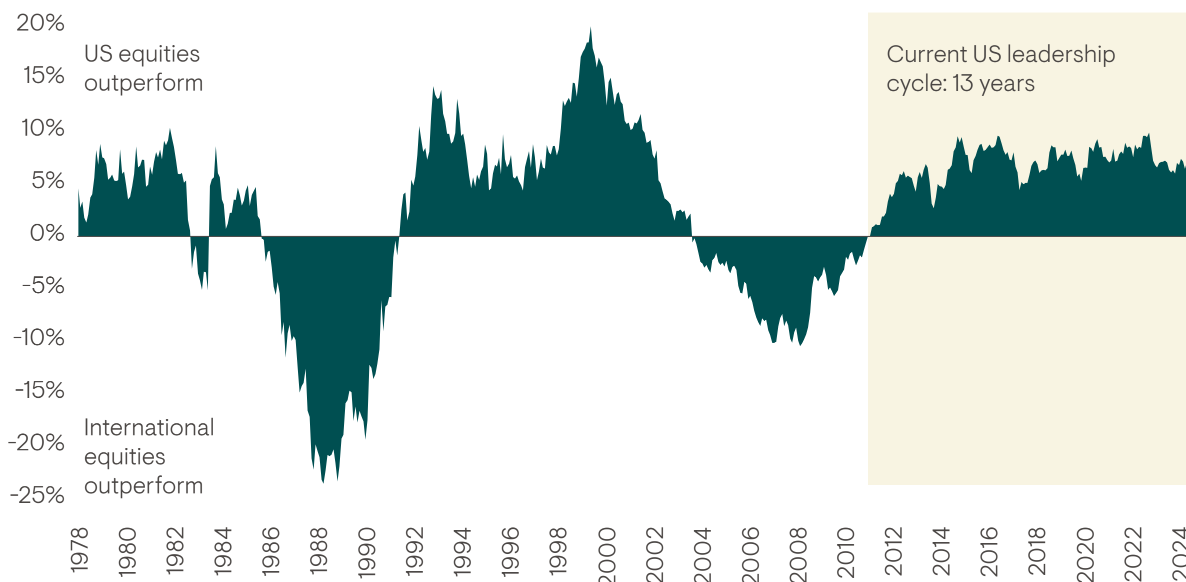
> A rich and highly diverse opportunity is missed by many investors

Why consider international now?

Since the end of 2022, US outperformance has increasingly been concentrated within a narrow group of large, momentum-driven stocks. Consequently, US benchmarks are now heavily overweight the technology[1] sector, with company concentration levels therein also at record levels. Furthermore, the 10 largest stocks in the S&P 500 account for 37% of the entire index, more than double the proportion from a decade ago, and six of the top 10 companies are IT stocks. This is hardly representative of the broader US economy. Idiosyncratic risk diversification has materially declined and altered the risk-reward equation for investing in US benchmarks: the -45% drawdown of the Magnificent Seven in 2022[2] — which dragged the S&P 500 down by 19%[3] – illustrates the implications. The market swoon of late July/early August this year provides a more recent example. Allocating to international equities may mitigate this growing risk while also expanding a portfolio's efficient frontier.

Historically, geographic market leadership has cycled with some regularity, and thirteen years of US superiority is well past the average of eight. The opportunity cost for trying to time this reversal has heretofore been significant, but longer-term precedent nonetheless suggests some accommodation for rotation risk is prudent, perhaps increasingly so.

Figure 2: US and international equities move in multi-year cycles



Source: Morningstar Direct, USD, MSCI EAFE NR USD and MSCI USA NR USD, June 2024. Chart compares rolling 5-year returns of US equities vs. international equities.

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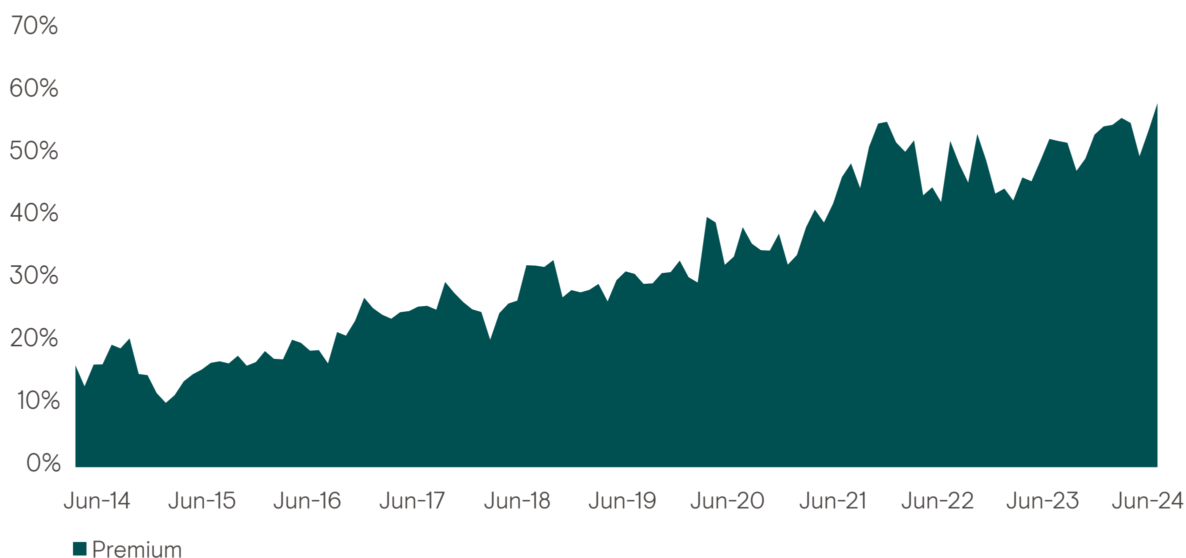
1. Information technology accounted for 32.5% of the S&P 500 as of June 30, 2024, up from 19.4% a decade earlier.
2. Market cap weighted average total return of: Microsoft, Apple, Alphabet, Meta, Tesla, Amazon, NVIDIA as of December 31, 2022.
3. Source: Bloomberg as of December 31, 2022.

For further information on indices, please see the Important information section.

The prevailing counterpoint is that US leadership is becoming more entrenched the longer it persists. Widening valuation differentials, illustrated in Figure 3, appear to increasingly capture this assertion.

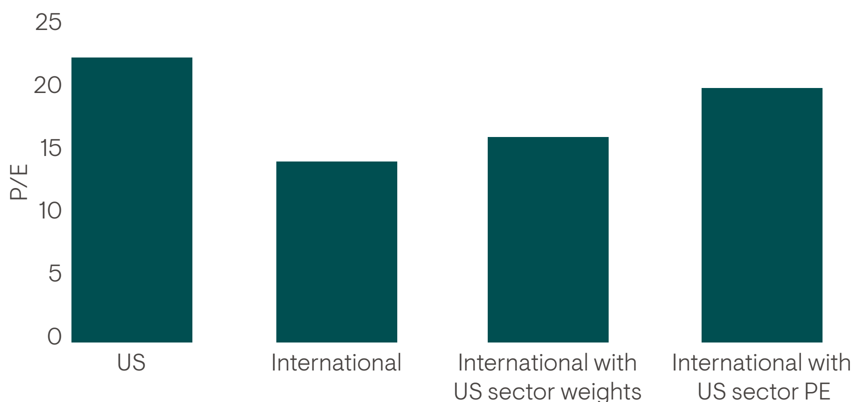
Figure 3: US equities have been trading at an increasing premium to international



Source: Bloomberg. Chart shows S&P 500 and MSCI ACWI ex-US 12-month forward P/E ratio differential in the decade through June 30, 2024.

This gap is often attributed to sector compositional differences (e.g. rising US tech overweight). However, even after accounting for these differences and also systematic valuation premiums, we still see international equities trading at a discount.

Figure 4: International is cheaper than US, even accounting for compositional differences



Source: Bloomberg, Ninety One, as of June 30, 2024. US equities are represented by the S&P 500. International equities are represented by the MSCI ACWI ex-US. The MSCI ACWI ex-US 12-month forward P/E ratio was adjusted by overlaying US sector weights in column 3 and US sector P/Es in column 4.
For further information on indices, please see the Important information section.

It's crucial, however, not to conflate low valuations with automatic mispricing. When considering fundamentals, especially earnings growth, leverage, and returns on capital, the US still comes out on top. Faster earnings growth is expected, with returns on invested capital also superior.

This raises a key question: does fundamental superiority justify staying US focused? Not necessarily, given how much the premium paid for these advantages has widened. What is clear, however, is that while a blunt, benchmark-level reallocation — US into international — would improve a portfolio's headline valuation, it would compromise key fundamental characteristics. Such a swap would be naïve, in our view.

Instead, an active, quality-focused approach is well-placed to capture the international opportunity without undermining critical attributes that drive returns. This is where Ninety One's International Franchise strategy comes into play.

International Franchise can capture the opportunity

Ninety One's International Franchise strategy seeks to compound investor value faster and more consistently than the broader market across a full market cycle. As we discussed earlier this year, we believe that a focused, quality-oriented portfolio – built on companies possessing the five key characteristics illustrated below – can be both an attractive alternative and also complement to classic investment styles, with the potential to deliver desirable, stable outcomes without sacrificing upside.

1. **Hard-to-replicate enduring competitive advantages**
2. **Dominant market positions in stable growing industries**
3. **Low sensitivity to the economic and market cycle**
4. **Healthy balance sheets and low capital intensity**
5. **Sustainable cash generation and effective capital allocation**

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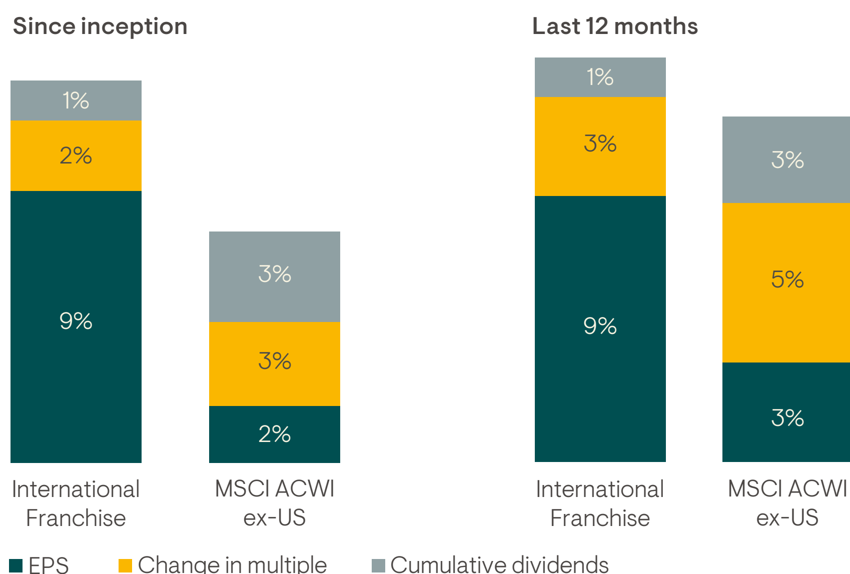
For further information on the investment process, please see the Important information section.

Elevating these quality characteristics alongside strong earnings growth can increase performance consistency across different market environments. Over the past 12 months, multiple expansion has contributed significantly to market returns; in other words, markets have recently become more expensive. Over longer periods, as illustrated by Figure 5, tangible fundamentals — earnings growth and dividends — emerge as the primary drivers of returns. This is our forte. While International Franchise has benefited from multiple expansion over the past year, earnings growth has been in line with its historical average, coming in around 9%.

Figure 5: Earnings growth is typically the primary driver of returns, not multiple expansion



Past performance does not predict future returns; losses may be made.
Source: Ninety One, FactSet, Bloomberg, June 30, 2024, based to 100 at December 2018. Based on a related portfolio with substantially similar objectives as those of the services being offered. Earnings based on Blended 12 month forward. Rating based on 12 month forward PE. Performance is derived from portfolio constituent through time and is based on the weighted average aggregation of EPS growth, rating change, dividend yield. The proportional contribution from the growth in EPS, PE change and cumulative dividends are allocated across headlined Net composite performance numbers.

Encouragingly, International Franchise has historically delivered significantly greater earnings growth than the international universe since inception, across a range of environments. In more challenging times, such as COVID, these earnings have demonstrated resilience. Earnings are the engine of a decent business. For us, what's important is that the engine of the businesses we invest in is thriving, and even though growth and momentum can drive the market on a short-term basis, the key underpin of our long-term value creation remains intact.

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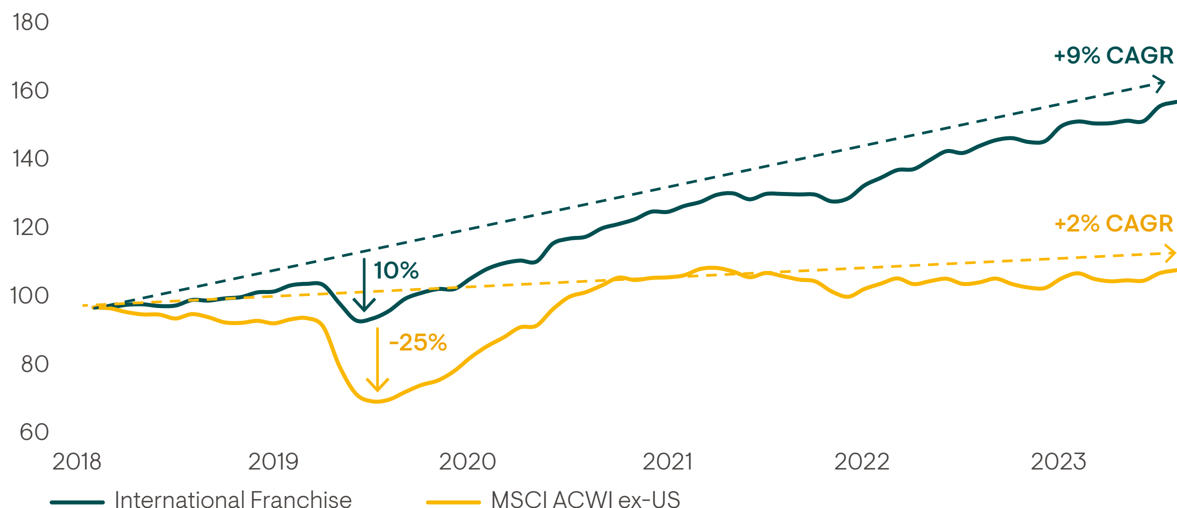
Figure 6: International Franchise's earnings have compounded at far higher rates than the broader market, demonstrating resilience when it matters most



Past performance does not predict future returns; losses may be made.
Source: Ninety One, FactSet, Bloomberg, March 31, 2024. Earnings are based on blended 12 month forward EPS. The above reflects the portfolio characteristics reweighted excluding cash and cash equivalents. Based on a related portfolio with substantially similar objectives as those of the services being offered.
Inception date: December 2018. Index: MSCI AC World ex USA (USD). CAGR is the compounded annual growth rate of earnings per shares on a 12 month forward basis on a weighted average basis that is based on portfolio holdings through time.

Within the quality spectrum more specifically, many world-leading companies are not captured by a US-centric approach. The common denominator among these businesses is a history of healthy free cash flow generation and successful reinvestment. The best of these companies often monetize unique intangible assets (such as patents, technology, and trademarks), which enjoy inherent protections to competition and can earn high returns on capital.

For example, we observe these dynamics in luxury house Hermes*, founded in Paris in 1837. Nearly two centuries of artisanal integrity has earned Hermes an enduring cache with consumers, a position underpinning its future growth. Other examples include the iconic beauty brands of L'Oreal (France) and the unique gaming titles of Nintendo (Japan), each robustly positioned within large, attractive markets.

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* No representation is being made that any investment will or is likely to achieve profits or losses similar to those achieved in the past, or that significant losses will be avoided.
The stocks were selected to demonstrate the breadth of international opportunity. None are material outperformers over the past 12 months. This is not a buy, sell or hold recommendation for any particular security. To evaluate the outcome of the strategy, see long-term performance. For further information on specific portfolio names, please see the Important information.

Closing thoughts

For investors seeking a broader universe to carry them through the next cycle, with downside protection, ex-US offers many quality companies that we believe have the potential to reward shareholders by compounding returns over time. Since inception, International Franchise has provided an attractive alternative and complement to classic investment styles, delivering desirable, stable outcomes without sacrificing upside. We believe that going forward, in a market where US leadership has become increasingly concentrated, it can also offer investors the chance to take some of this unnecessary risk off the table and have the potential for a smoother journey to their desired outcome.

International Franchise performance history (%)

	1 year	5 years p.a.	Since inception p.a.
International Franchise	12.9	8.3	11.3
Benchmark	9.7	6.3	7.8
Active return	3.1	1.9	3.5

Past performance does not predict future returns; losses may be made. Downside protection is not guaranteed.

Source: Ninety One, July 31, 2024. Net performance is net of the highest institutional segregated portfolio management fee. Income is reinvested, in USD. Performance start: 01 January 2019. Benchmark: MSCI AC World ex-US NDR. Indices are shown for illustrative purposes only.

General risks. The value of investments, and any income generated from them, can fall as well as rise. Costs and charges will reduce the current and future value of investments. Past performance does not predict future returns. Investment objectives may not necessarily be achieved; losses may be made. Target returns are hypothetical returns and do not represent actual performance. Actual returns may differ significantly. Environmental, social or governance related risk events or factors, if they occur, could cause a negative impact on the value of investments.

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