The Great Debate: Non-U.S. Growth vs. Value Equities

When it comes to finding compelling investment opportunities outside the U.S., style may not matter as much as you think.

KEY TAKEAWAYS

- We believe this is a great time to consider non-U.S. equities. Valuations are attractive and earnings growth is improving, creating opportunities for growth and value managers alike.
- Style labels don't tell the full story. We believe it's better to focus on a manager's approach to investing when determining how to pursue opportunities in non-U.S. markets.
- Leadership by growth or value is cyclical – investors may benefit by allocating to both.

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THE CASE FOR NON-U.S. EQUITIES

Valuations

U.S. equities have enjoyed a long run of outperformance that has widened the valuation gap between U.S. and non-U.S. equities. Indeed, the forward P/E of the MSCI EAFE Index versus the S&P 500 Index is at a 20-year low. Surprisingly, this is happening at a time when the earnings growth of non-U.S. stocks is improving.

Other valuation metrics tell a similar story. Price/book (P/B) of the MSCI EAFE looks even cheaper, trading at a 57% discount to the S&P 500*. We believe this bodes well for stocks outside the U.S.

Earnings Growth Potential

We also believe the potential strong earnings growth in non-U.S. markets has staying power, as record amounts of fiscal stimulus and accommodative monetary policy are supporting improvement in growth. The sharp improvement in global growth has led to a change in earnings expectations. Growth is broadening to multiple sectors and industries, and cyclical industries are experiencing some of the strongest recoveries. In fact, we believe there is the potential for positive earnings growth in all sectors through 2022. We think the broader composition of the non-U.S. equity universe sets it up for long-duration outperformance.

To illustrate, consider the recent outperformance of the S&P 500. Over the last five years, the S&P 500 outpaced the MSCI EAFE by 6,700 basis points*. However, 40% of that excess return was attributable to just five stocks comprising 22% of the index: Apple, Microsoft, Facebook, Alphabet and Amazon. These are solid companies that may continue to post strong earnings results, but they also benefited from the scarcity in growth for the last few years during a global earnings recession.

If a global synchronized recovery in earnings accelerates, as we expect, we believe growth should broaden to multiple sectors and industries. This would benefit non-U.S. markets, which are more broadly diversified than the U.S.

*Data as of 4/30/2021.
Source: Bloomberg, FactSet.

THE GREAT DEBATE: GROWTH OR VALUE?

In this environment, many U.S. investors are underweight non-U.S. equities even though they make up close to two-thirds of the world's market cap. Countries outside the U.S. now account for about 75% of global GDP and about two-thirds of the world's market capitalization. This is a mismatch with the typical investor allocation of about 15% to 20% in non-U.S. equities.

Investors deciding to increase allocation to non-U.S. equities often consider a growth or value approach. Client Portfolio Manager Laura Granger recently sat down with Raj Gandhi, Senior Portfolio Manager, Global Growth Equity and Al Polit, Senior Portfolio Manager, Global Value Equity, to debate the merits of taking a growth- or value-oriented approach to investing in non-U.S. stocks. This spirited debate delivered some surprising insights from both managers.

Granger: Should investors consider a growth or value investing approach if they want to capitalize on a potential recovery in non-U.S. stocks?

Rajesh Gandhi: Our experience has been that stock prices follow earnings over the medium to long term, and, therefore, the direction of earnings is what matters most. The growth philosophy we employ seeks companies whose earnings growth is accelerating and can be sustained over the medium to long term. The key is that the market must be rewarding companies for earnings. That is the type of market we expect as we move into the summer. In our view, a disciplined growth approach focused on identifying inflection in fundamentals leading to sustained earnings growth will perform better than watching Al waiting for the next blue light special at K-Mart.

Earnings Growth Matters

In an environment where economic and earnings growth is accelerating, there are many more opportunities in the market outside traditional secular growth sectors such as technology, health care or consumer-facing companies. As underlying growth accelerates, growth tends to broaden out to cyclical sectors such as industrials, materials and even financials, providing an abundant set of options.

We are entering a period where the underlying drivers of earnings growth have shifted from more defensive and secular sectors to more economically sensitive arenas.

Tailwinds for Growth

As the global economy exits the effects of the pandemic, we expect a sustained resurgence in growth for the next few years. Accommodative central bank policy, a surge in fiscal stimulus, pent-up consumer demand and years of underinvestment in capital expenditures support this view.

Our team has identified many new ideas tied to this cyclical improvement. However, we have not eliminated exposure to core long-term growth companies in the technology and consumer sectors.

In sum, we don't endorse taking a strictly traditional growth or traditional value approach. Instead, we believe our process, which focuses on identifying inflection in a company's fundamentals, will lead us to sustained high earnings growth and better performance than watching my esteemed colleague go dumpster diving or waiting for the next blue-light special at K-Mart!

Granger: That makes sense given the expectations for strong earnings recovery. Al, same question: would investors be better served with a growth or value approach?

Al Polit: Well, while Raj was busy focusing on earnings growth and highlighting my quest to find bargains at the local K-Mart, he neglected to even mention the word "price." Price does matter. So, Raj can keep paying $10 for that mango at Whole Foods, and I'll gladly pay 50 cents on the corner.

Look, this is what we believe: markets are grossly inefficient, motivated by fear and greed rather than fundamentals. In our view, the way to beat the averages over the long term is to view publicly traded equities as small pieces of a business that are up for sale the same way a rationale private-equity-minded businessperson would. Investors should look through the noise using a long-term time horizon.

We believe the keys to success are identifying that intrinsic worth and then taking a margin of safety, or discount, and only paying that much for a name, ultimately generating an asymmetrical risk-reward profile with limited downside and substantial capital appreciation potential.

Price Does Matter

The focus is on price! It's not rocket science. But it requires patience and discipline, something that has admittedly been difficult in recent growthy markets. Yet, history has shown that value-minded investors are ultimately rewarded. It's like those Jordache jeans that Raj once paid $200 for because they were the next big thing. I waited patiently and bought them for $15 at the flea market and now they're worth $30. Price does matter. Patience is rewarded.

Price-to-value spreads between growth and value across almost any set of indices you use will draw a similar conclusion. Growth is more expensive today than it has been historically, making value more appealing. If history repeats, I believe price-focused investors could come out ahead.

Tailwinds for Value

We are bottom-up investors but also believe several things should help markets close that price/valuation gap.

First are rising rates. Growthy companies that rely more on future growth become less attractive with rising rates. It's simple math. A higher discount rate will decrease the value of future cash flows. At the same time, those that are earning more steadily today become more attractive.

Second are interest rate spreads. The market is still not appreciating many non-U.S. banks. Over the last 10 years, non-U.S. financials were half of the detractor when you compare the MSCI ACWI ex-U.S. Core to the Value index.

Why? If we go back to the global financial crisis, then the euro crisis and the pandemic, the continued environment of low spreads and lax demand for loans has affected traditional bank profitability. This is likely to reverse as loan demand once again accelerates, spending increases and the yield curve gets steeper. And banks have better balance sheets than at any time in history. Also, let's not forget that cross-border consolidation chatter with European banks is gaining momentum, thus pushing more in-market consolidation as existing players position themselves.

Such actions may be value accretive and provide further upside. We think the "price does matter" rotation is just getting started as the market comes to its senses and realizes that what one pays for an investment does truly matter—all with a little help from a more normal rate environment.

THE PROBLEM WITH STYLE INDICES

Granger: The financial media tends to focus the debate of growth versus value through the lens of style indices rather than characteristics or factors. Index composition doesn't always match the style characteristics one would expect. For example, there are stocks with similar characteristics in both growth and value indices, depending on where we are in an economic cycle.

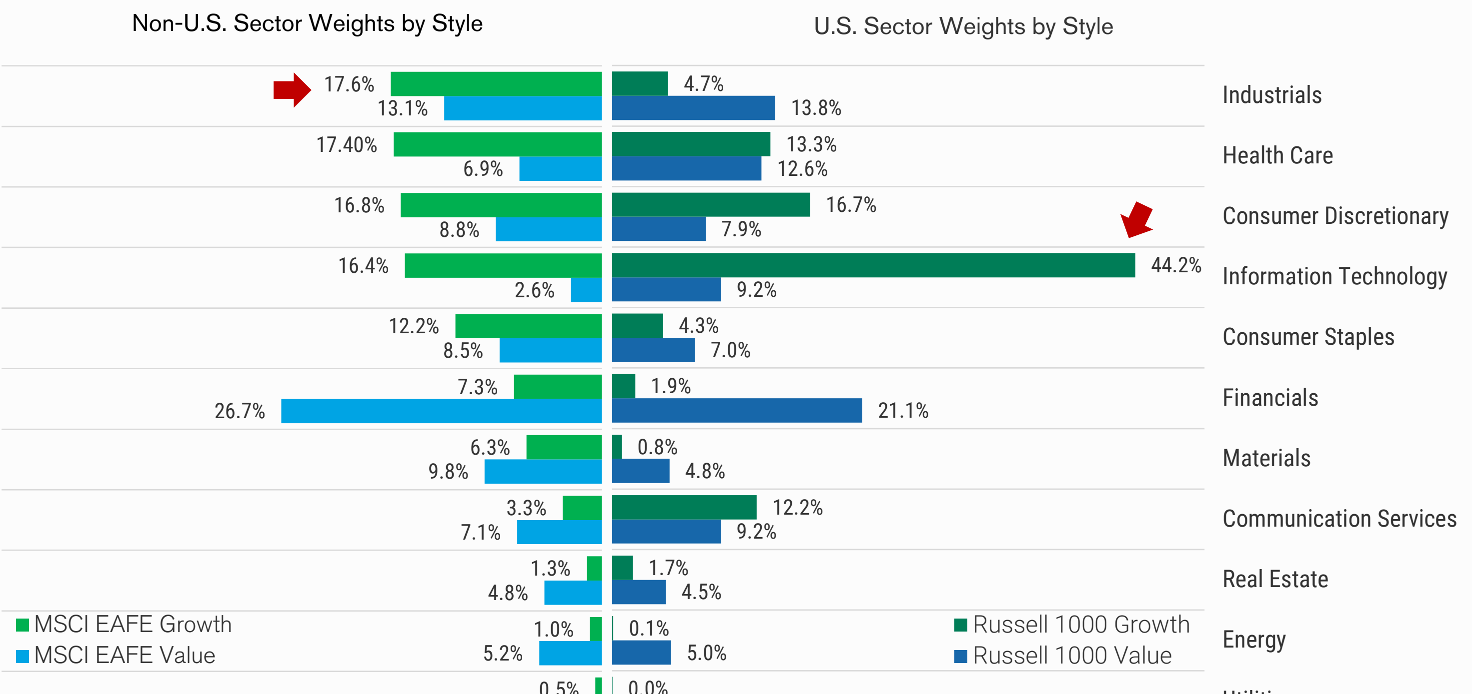
There are also differences in the composition of key U.S. and non-U.S. indices. The U.S. is highly concentrated, with a 45% weight in information technology in Russell 1000 Growth versus only 16% for MSCI EAFE Growth (Figure 1). This helps to explain the focus on technology in most discussions about U.S. growth stocks.

On the other hand, industrials represent the largest weight in the MSCI EAFE Growth index and is higher weight than the U.S. Value index. It is important to be aware of these differences in composition when evaluating style index performance.

Al, do you believe style indices are the best way to evaluate manager performance or predict value vs. growth?

Polit: The short answer is not exactly. Every style index has its flaws. The general method for determining growth and value indices is to sort core constituents by select valuation metrics from high to low. Then, the top and bottom are equally split by market cap; the top are considered growth while the bottom are in the value camp.

Figure 1 | The Growth vs. Value Debate Is Different in Non-U.S. Markets



Data as of 4/30/2021. Source: FactSet.

Seems simple enough but think about it. If every company in that core benchmark were truly growth and had no earnings, half would still be in the value benchmark based on that overly simplistic methodology. Viewed another way, if the index were composed of companies that still manufactured rotary phones, half of those companies would fall into the value categorization.

Fundamental traits are absent from the value/growth style assessment. Balance sheet risks are also not considered. Business sustainability assessments are not factored in either. Samsung Electronics alone is 40% of the MSCI Korea Value Index. It is certainly not value at these levels. My point is that style benchmarks were created to try to make some sense of the investable universe, yet there are obvious flaws.

Our strategy sticks out even among our industry peers because we consider ourselves to be absolute value, not relative value. This further removes us from the value style index, and with our already high tracking error, means the style index has even less predictive power. Yes, the value benchmark may have greater correlation with our strategy at times, but at other times, not so much.

Thus, we're style-index agnostic. We simply buy businesses trading at attractive prices regardless of which index provider put them in a certain bucket, so use style benchmarks cautiously.

Granger: Raj, what are your thoughts on the growth style index versus investment characteristics or factors you look for?

Gandhi: In investing, there is no perfect index. Style indices are concocted by statisticians trying to pigeonhole investors into specific buckets. This implies screening for stocks is easy, and it's not. It's a combination of science and art that requires connecting many different fundamental data points.

Growth indices typically include companies with sustained strong revenue and earnings growth over time and sometimes put more weight on highly valued (e.g., high P/E) companies. These characteristics are misaligned with our approach to growth investing, which is focused on finding accelerating and sustainable growth. Our process is focused on the direction of earnings growth, not the level of growth. Therefore, it presents a much larger opportunity set that is sector and quality agnostic.

We See Both Cyclical and Secular Opportunities for Growth

Our team is finding both cyclical improvement opportunities and secular beneficiaries. Many such opportunities are, in fact, core members of the value index.

These include companies whose earnings are beginning to accelerate, such as Ashtead, the U.K.-based equipment rental company. Another is Safran in France, a company that manufactures and services the engines on the Boeing 737 and Airbus A320. We also continue to see high upside potential in long-term outperformers. Examples include Puma, the German shoe and apparel company, and Adyen, a global leader in online payments.

Multiple expansion, which has disproportionately favored low-quality, high-beta stocks, has lifted the market from the lows of last summer. We believe we are at a turning point now that earnings are starting to accelerate.

The pandemic changed behavior among consumers and businesses, leading to new or enhanced growth opportunities. Furthermore, a surge in government spending should provide an additional boost to many companies, and interest rates are expected to remain low. Therefore, we expect companies with strong earnings growth potential to continue to outperform.

WHAT WILL DETERMINE THE DURABILITY OF VALUE PERFORMANCE?

Granger: You both make good points about why investors should focus on manager approach rather than style index performance. However, the value index has outperformed the growth index by well over 1000 bps since the announcement of the vaccines in November 2020. Raj, you brought up a good point about the market's recent rebound. Much of the rally has been driven by multiple expansion. Some like to characterize the last six months of value outperformance as largely being driven by the re-rating of either lower P/E names or previously underperforming stocks—especially in financials and energy

Raj, what factors should investors focus on moving forward? What will determine if the value rally continues?

Gandhi: In our view, the key variable is the sustainability of earnings growth and finding situations where the true earnings potential is not factored into consensus expectations. For example, in response to the pandemic, companies have instituted short-term measures to protect profits, including employee furlough schemes or pulling back on travel expenses. These types of cost cuts are temporary. We've spent a lot of time identifying which companies may benefit from long-lasting changes in behavior—enabling stronger and more sustainable growth.

Behavioral Changes Are Creating Opportunities

Take the IT services sector, for example. Before the pandemic, companies had already begun migrating infrastructure to the cloud and upgrade their communication infrastructure so they could reach customers through digital apps. The pandemic and experience of companies during the lockdown revealed significant shortfalls in IT infrastructure. As a result, we've seen an acceleration in IT spending on digital transformation projects.

Cap Gemini of France is a direct beneficiary of this increase in spending. Cap Gem has a global presence, with onshore consultants who interface with C-level executives. They have also built a large offshore design and implementation team in India, which enables delivery of these solutions at a competitive cost. The company is starting to see growth accelerate, as evidenced by a rise in their bookings. We believe this will lead to accelerating earnings growth and positive earnings revisions.

Another example is Cemex, the global cement company headquartered in Mexico. Many countries' fiscal stimulus packages include programs to boost infrastructure investment as well as subsidies to stimulate spending on housing. We see this in markets where Cemex has operations, including Mexico, Europe and potentially the U.S.

President Joe Biden's infrastructure plan, if passed, could potentially add 5% to 8% to annual cement demand over the next five years when utilization rates are already running at high levels. We expect not only volume growth to accelerate but pricing to rebound, which could result in strong operating leverage and earnings acceleration.

Granger: From a value perspective, do you believe the recent value rally was a typical early cycle, short-lived beta re-rating, or is there durability in value's outperformance?

Polit: After hearing Raj's response, I'm reminded of a phrase Ronald Reagan used during the presidential debates against Jimmy Carter, "There you go again." Raj never once mentioned price.

The work-from-home companies will start losing market momentum, the pandemic will subside, and the millennials will get back to work and spend less time on Reddit. We think markets will continue to acknowledge the value rotation and appreciate that price does matter. This price-focused value rotation has started and will only get stronger, in our view, given fundamentals and current prices. In the meantime, our goal is to take advantage of the disarray by buying businesses trading at attractive prices with downside protection.

We think one such nickel (not diamond) in the rough is Norilsk, a Russian mining company. In our view, the firm offers compelling value because of its attractive price, its strong balance sheet, and the fact that it is among the lowest-cost producers in each of its mining segments. Our research shows Norilsk offers an attractive growth profile over the next decade, as decarbonization initiatives throughout the world boost demand for nickel, palladium and copper. Supplies are already constrained and will struggle to keep up with demand growth due to the limited available resources and long lead times for mine development.

We believe the company's strong balance sheet, cash flow generation and access to attractive and low-cost untapped resources also bode well for long-term growth.

That said, the key is that the current price is attractive.

Granger: Can you give us another example of a compelling opportunity that you've uncovered with your growth approach?

Gandhi: We like a company called Techtronic Industries. It is Hong Kong-based global leader in the power tools industry, competing head-to-head with Stanley Black and Decker. Techtronic owns the Milwaukee Tool and Ryobi brands, which you may have seen at your local home improvement store. Techtronic generates close to 70% of its revenue in the U.S.

We anticipated a long-term resurgence in power tool demand due to the work-from-home and nesting dynamic, as consumers diverted spending from travel to home improvement. This has played out—the company reported 44% revenue growth in the second half of last year.

Techtronic has also outspent its peers on R&D, resulting in the development of more innovative products. For example, Milwaukee's MX Fuel™ Equipment Systems are helping the company gain share in the fast-growing cordless tool market. These products offer longer battery life, more power, and greater torque. Despite the stock being up 133% over the last year, we believe the Street continues to underestimate the earnings power of this business.

Granger: How about on the value side? Can you give us an example of where your team is finding value now?

Polit: Raj may be surprised to hear that a dumpster diver like me found BMW attractive as the pandemic was surfacing and its price was appealing. BMW has leveraged its strong brand and technology and taken share from smaller automakers without the scale or resources to make the necessary investments to transition to electric vehicles or autonomous driving. Despite the strong share performance over the last year, the quality of the company and its product pipeline are still not fully reflected in the share price, in our view.

Gandhi: I'm glad to see you're not simply buying old Pintos. We like Daimler, owner of the Mercedes brand. Mercedes has begun to benefit from an overall rebound in luxury car demand. It is also in the early phase of launching new models across its major markets.

For example, it recently launched a new generation of the S class, its most profitable car. We believe improving demand, coupled with the new model launches, will boost volume growth and lead to an improvement in margins.

As we look longer term, Mercedes has spent billions of dollars in developing a world-class electric drive train platform. We think the products coming off this platform should allow Mercedes to capitalize on the transition to EVs.

In fact, it revealed its first vehicle on this platform last month—the EQS, which will be in showrooms this fall. The EQS will compete head-to-head with the Tesla Model S, and it possesses some key superior features like a longer range and shorter charging times. For all these reasons, we believe Daimler appears positioned to see accelerating and sustainable earnings growth.

Polit: Well, Raj, we like Daimler, too. I agree with a lot of what you said about the company. It has made significant investments in R&D as well as in software development.

I also agree about the highly anticipated EQS competing with premium EVs. I would add that the trucks and buses division spinoff should be completed by year-end, which we think is positive.

An underappreciated asset is the financing division. Its extremely low credit losses reflect an inherently low-risk customer base. Its return on equity averaged 14% over the last four years despite a dip in 2020 due to COVID-19. And, even after a nice run-up, we still like the price.

Granger: Thanks, Raj and Al. Daimler is a great example of how we can look at a stock from different angles yet draw similar conclusions. You each make compelling arguments. The reality is the outperformance of growth and value goes through cycles that are difficult to predict, and investors may benefit by staying allocated to both.

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