



Seeking Value Around the Globe

BY JAMES HUNT ON *JULY 31, 2024*

When I became partner at Tocqueville in 2000, we were at the tail end of the dotcom bubble. The previous five years had been characterized by a surge in technological innovation around the Internet, with U.S. companies leading the way. In equity markets, this resulted in a concentration of interest and fund flows into U.S. technology stocks, a steady march higher of U.S. technology stock valuations, a period of unprecedented outperformance by U.S. markets over non-U.S., and subsequently, a decided lack of interest in non-U.S. securities (and old economy stocks). Investor neglect resulted in compelling valuations overseas, and we capitalized on behalf of our clients.

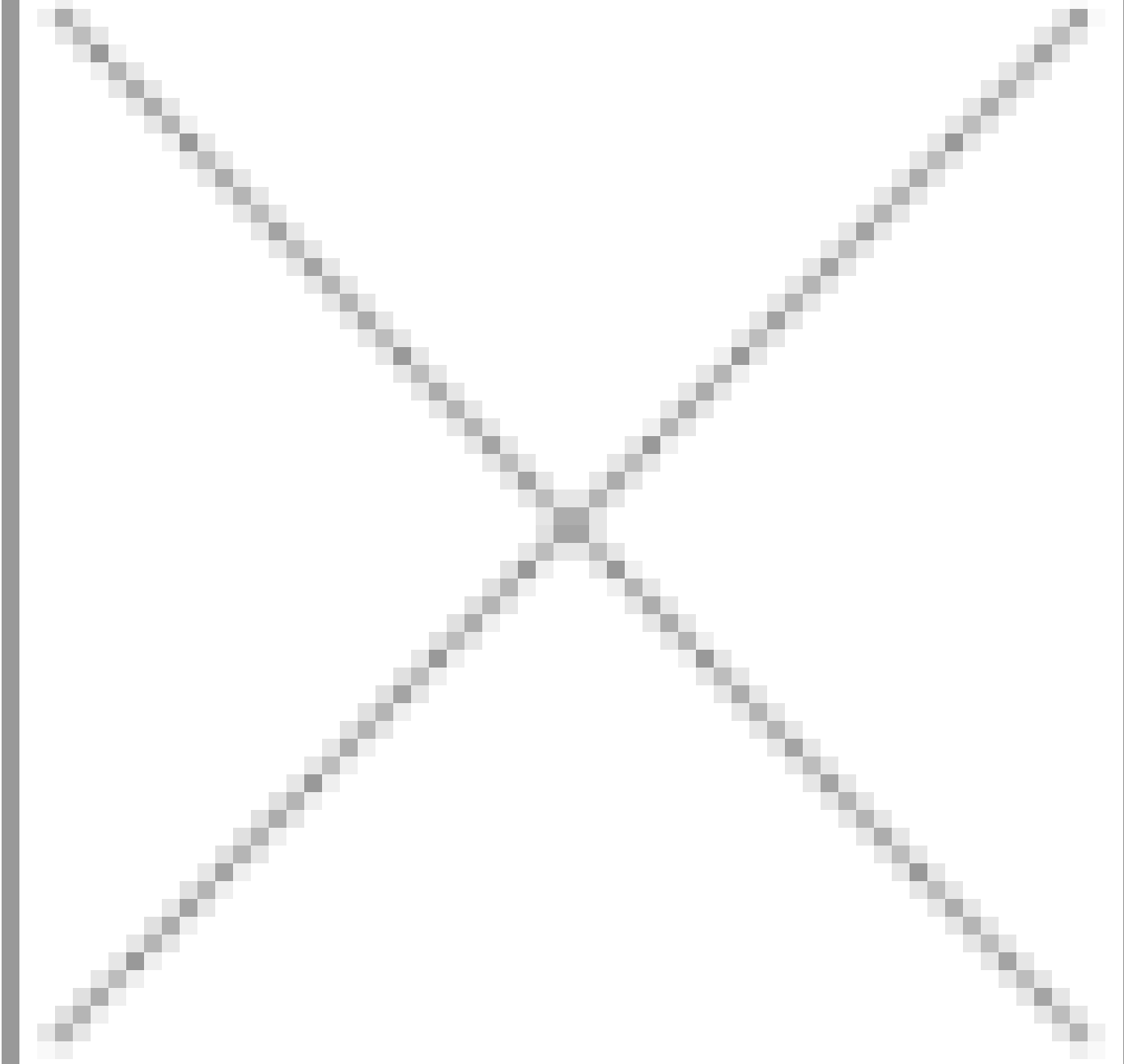
When investment sanity prevailed, the dotcom bubble burst, and the technology laden NASDAQ declined by over 70% from its peak. The tides shifted back to non-U.S. markets (and old economy stocks returned), and a roughly seven-year period ensued when non-U.S. markets outperformed U.S. markets by over 60%.

Tocqueville's Global investment strategy flourished in this new context. From inception in mid-2003 until the end of 2007, our strategy outperformed the S&P 500 by over 40%. There were several sources of alpha in the portfolio, but thematically the dominant factor that explains the high return was a large exposure to non-U.S. stocks relative to U.S.

Today's environment seems roughly comparable to that at the end of the dotcom bubble. Since the GFC, U.S. stocks have dominated non-U.S. stocks in one of the longest running periods of outperformance on record (see below from the recent JP Morgan Guide to the Markets).

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As a result, interestingly, the U.S. representation in Global Indices has now increased from around 45% to an unprecedented 65%. Meanwhile, Europe and Japan combined have declined to roughly 17%. In contrast, the U.S. GDP is \$27 trillion, while the combined GDP of Europe and Japan is \$22 trillion, implying a U.S. market cap to GDP ratio 3 times that of combined Europe and Japan.

Comparing the valuation of U.S. indices with non-U.S. indices tells a similar tale. Per the chart below, the ACWI ex-U.S. stock index, is trading at a 36% discount to the S&P 500 on a current price-to-earnings (P/E) ratio basis, the lowest level in twenty years.

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The most recent phase of this U.S. outperformance and growing valuation disparity has been driven by the famous Magnificent 7. To be clear, we consider most of the Mag 7 to be great businesses, with wide competitive moats, pricing power, ample free cash flow, net cash balance sheets, and importantly legitimate exposure to artificial intelligence spend. And we do not mean to suggest an analogy with the loss-making Internet companies of the late 90s that were valued on the basis of “eyeballs”. *What is similar is that global investor interest in these companies has attracted capital at the expense of other areas of the market and has resulted in a high level of market concentration and full valuations among large cap technology shares. These tendencies are exaggerated by the prevalence of passive investing.*

To be balanced, the outperformance of U.S. markets since 2010 can be explained in part by superior growth in U.S. corporate earnings. Also, we recognize that a simple comparison of index P/E based valuations is not entirely fair for reasons ranging from index composition to accounting practices. For example, the S&P 500 is populated by companies that earn a higher return on invested capital than their non-U.S. counterparts, meriting a higher multiple of earnings.

That said, with the discrepancy in performance and valuation at apparent extremes, it does beg the question of whether better values might exist outside the U.S. With investors in general so overexposed to the Mag 7, the potential for a reversal is real.

There is evidence of fundamental improvement outside the U.S. Japan appears to be winning its fight to grow wages and inflation, and corporate Japan is engaged in a multi-year process of improving efficiency, margins and returns on capital. India is pursuing a coherent GDP growth strategy. Weakness persists in China, but the nation seems to be turning the corner on its Covid and supply chain logistic issues. Europe's economy is muddling through, but the great global franchises in Europe continue to impress.

As bottom-up fundamental investors, we always revert from discussions of indices to the level of the individual company. In that context, we ask ourselves whether investor appetite for U.S. stocks and passive investing have resulted in a situation where certain non-U.S. companies with good businesses and comparable geographic revenue exposures trade at an unwarranted and meaningful discount to their U.S. peers. The answer to this question is a resounding yes. Whether it is a medical technology company in the U.K., or a leading industrial software and automation business in Germany, or a gaming company in Japan, these internationally domiciled companies compete globally against their U.S. peers. However, despite being in the same businesses, and having in some cases more attractive financial metrics, the non-U.S. players are trading at a discount to their publicly traded U.S. competitors, and therein, we believe, lays the investment opportunity.

There are indeed risks which have encouraged investors to take comfort in U.S. securities in lieu of non-U.S. Geopolitics have become marginally more complicated, with no improvement in the Middle East and Ukraine. Elections in France, Mexico, India and elsewhere have produced some unexpected outcomes and stirred uncertainty. The U.S. election is a bit of a wild card. A Trump victory could result in a resumption of more aggressive trade policy, a negative for growth outside the U.S. That said, both candidates seem likely to pursue economic policies that result in more debt, which would tend to produce inflation and put pressure on the U.S. dollar, which historically has been good for both the local currency and U.S. dollar value of non-U.S. markets.

It is hard to know what could spark investors to acknowledge the mispriced securities we see outside the U.S. and when investment flows might follow. As long-term investors, we are willing to be patient, and we are comfortable owning shares of companies that, based on our rigorous due diligence, have defensible business franchises, generate attractive returns and free cash flow over a cycle, retain strong balance sheets, and trade at a discount to our estimate of intrinsic value.

James Hunt

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