Equity Insights
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# International Large Cap Value

## The Forgotten Asset Class


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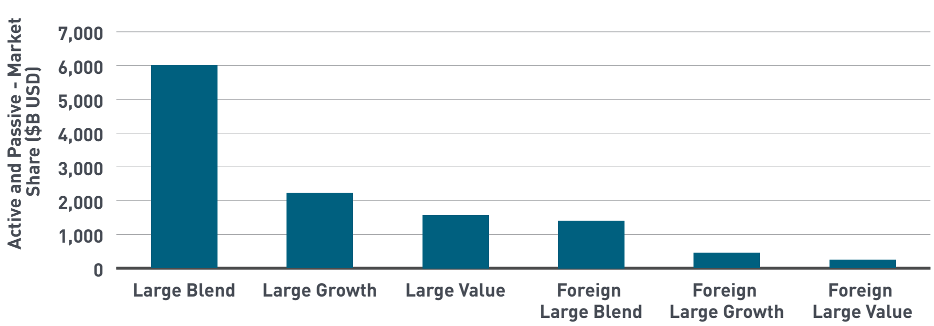
### Key Takeaways

- Investor allocation to the international value asset class are at historically low levels, driven largely by an under allocation to non-US equities and intensified by ongoing concentration risk in US benchmarks.
- While US equities, most notably technology and growth stocks, have been in favor for the last decade, history has shown that market leadership between US and non-US stocks, as well as growth and value, tends to rotate over time.
- Today's macro landscape (higher inflation, higher interest rates, peak US dollar?) and the relative valuation spread between US and international value stocks, coupled with the concentration risk in US indices, is reminiscent of the last period of sustained outperformance by the international value asset class.
- Importantly, investors looking to capture the benefits of diversification would be well served by an allocation to international large cap value given its sector composition and the low correlation of the asset class to US equity markets.

For much of the past decade, a backdrop of declining interest rates and inflation expectations led investors to favor long-duration growth equities above all, dismissing the long-term benefits of diversification. With its technology-heavy orientation, the US market, using the S&P 500 Index as a proxy, generated an annualized return of 11.9% over the past 10 years through September 2023. The S&P 500 technology sector, which makes up 30% of the S&P 500 Index today, generated an annualized 20.4%. On the other hand, the MSCI EAFE Value Index, with its meaningful weights to out-of-favor areas of the market such as banks, metals and mining companies and major oil companies, returned a paltry 3%. Not surprisingly, over this period we witnessed a surge in allocations to the growth-centric US market, leaving international asset classes, and in particular the international large cap value asset class, in the dust by comparison (Exhibit 1).

### Exhibit 1: Investors Extremely Overallocated to US Equity Markets Relative to International




Source: Morningstar, Inc. Data as of 30 September 2023.

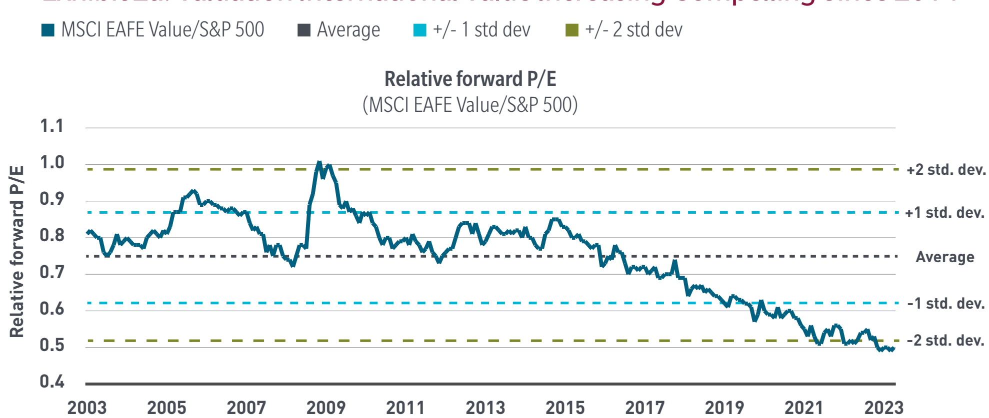
Given the euphoria surrounding US equities, and technology stocks in particular, investors appear to have lost sight of the fact that there have been several extended periods of time during which international value stocks were in favor. At the outset of one of these time periods, the US dollar had appreciated by 24%, the S&P 500 had outperformed the EAFE Value Index by 7.2% annualized over the ten years prior, and the US equity market had become heavily concentrated in high-flying technology stocks. This was also a period where the 10-year treasury rate stood at 5.25% and world inflation at 3.8%. From a valuation standpoint, US equities were trading at a 60% premium to international equities on a cyclically adjusted basis following a period of massive multiple expansion in the US market driven by a belief that a technology born 20 years earlier had finally evolved into something nearly invaluable. Sounds familiar, right? No, we're not referring to today, but rather to January of 2001. We all know what happened next, as this was the backdrop in the lead up to the dot-com bubble in the United States.

As we sit here today, the US dollar has appreciated by 32% and the S&P 500 has outperformed EAFE Value by 8.9% annualized over the past 10 years. The ten-year treasury sits at 4.6%, as of September 30, 2023, global inflation is at 4% and the US market trades at a 130% premium to the international market. Further, it has been 20 years since the end of the last "AI winter," and investors have now hung their hats on Large Language Models, a form of AI, as a technology that has evolved into something nearly invaluable.

Importantly, what happened after the dot-com bubble is where we want to focus today, as it will be the backdrop over the next ten years, not the last ten, that will drive investor returns.

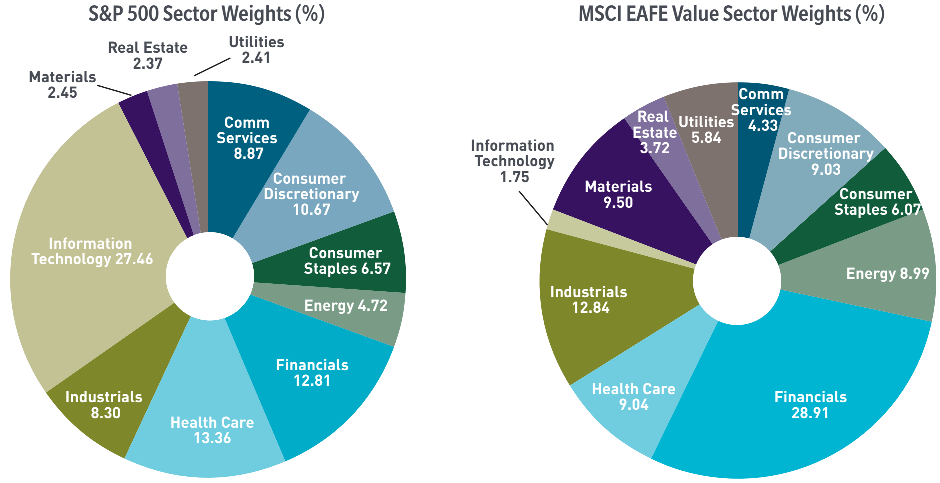
Over the 2000's business cycle, from March of 2001 through December 2007, the MSCI EAFE Value Index generated an annualized return of 10.9%. This was nearly three times the return of the S&P 500, which generated a return of 4.1%, with its technology sector generating a return of 0.35% over that same period. While the 30% drop of the S&P 500's CAPE (cyclically-adjusted price-earnings ratio) over this period was a large driver of poor US market returns, this is not what drove the international value market's nearly 11% annualized return. Before we delve into the drivers of return, it's important to set the stage by comparing the market structure of the S&P 500 and the MSCI EAFE Value Index, as the two could not be more different. Perhaps the most notable difference — besides valuations now trading over two standard deviations "cheap" relative to the S&P 500 — is that the S&P 500's large technology weight is made up in the EAFE Value universe through cyclical and shorter-duration sectors such as financials, materials, industrials and energy (Exhibits 2a and 2b).

### Exhibit 2a: Valuation International Value Increasing Compelling Since 2014




Source: FactSet Market Aggregates. Monthly data as of 31 July 2003 to 30 September 2023. Forward price-to-earnings (P/E) are next-twelve-months using mean broken estimates provided by FactSet.

## Exhibit 2b: While S&P 500 is Dominated by IT, the EAFE Value is Diversified across Cyclical and Shorter-Duration Sectors




Source: Factset. Data as of 30 September 2023.

Below we explore various factors that led to the solid returns from the international value market in the wake of the dot-com bubble and considering the structural differences mentioned above.

## Currency

In the aftermath of the dot-com bubble, investors sought opportunity outside the United States, and the US Dollar (USD) depreciated by 40% from market peak through 2007. From a US investor perspective, this depreciation added to non-US local stock returns as those returns were translated back to USD. Today, while the USD remains strong versus history, the currency has depreciated by 5% for the 12 months ended September 30, 2023, and perhaps downside pressures could persist as the end of tightening efforts by the US Federal Reserve is believed to be in sight.

## The Currency/Commodities/Industrials Link

During the 2000's business cycle, international materials, energy and industrial companies were akin to the US tech companies of the 2010's. The MSCI EAFE metals & mining and MSCI energy indices advanced a combined 26.3% annualized over the six years through 2007. The USD is the benchmark mechanism for pricing most commodities globally, including lead, silver, soybeans and oil. Over long periods of time, there has been an inverse relationship between commodity prices and the USD. That is, as the USD weakens, the demand for commodities tends to rise as foreign buyers of commodities use US dollars to purchase more than they can with their local currency, and in turn purchase commodities at a discount. As a knock-on effect for the industrials sector, the production and extraction of commodities can't be achieved without equipment, including tractors, pumps, trucks, excavators, etc. That said, there have been instances of the relationship not holding up, but there has certainly been a historical relationship that can't be ignored.

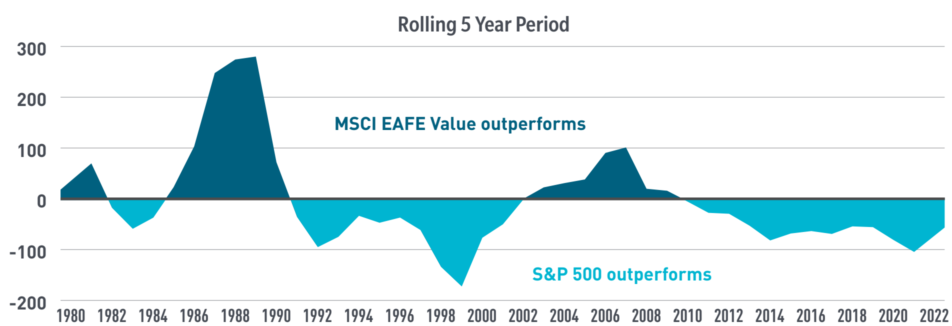
## The Inflation/Banking Link

As we have seen over the past year and a half, when inflation is rising or remains elevated against a backdrop of a healthy economy, central banks will step in and increase interest rates to keep prices under control. While the narrative today is that inflation will decline in an orderly fashion down to central bank target, resulting in dovish pivots and lower rates moving forward, there is an outsized possibility that the inflation story is not complete. In fact, the news as of late highlights that we may be in the early innings of wage/price inflation. For example, various auto manufacturers and airlines have increases through union negotiations. In addition, oil prices have recently rebounded after OPEC+ supply cuts, renewed conflict in the middle east, and readings of forward inflation expectation such as the US 5yr and the University of Michigan 5-10yr are on the rise again. Should elevated inflation hang around longer than expected, banks could become beneficiaries of higher rates if the economy doesn't dip into a protracted recession. This may be particularly true for international banks, since this unloved area of the market, which has dealt with stringent regulations and measly net interest income since the sovereign banking crisis, is now dramatically de-risked and de-levered, consolidated, and trading at attractive valuations — below book in many cases.

## Diversification

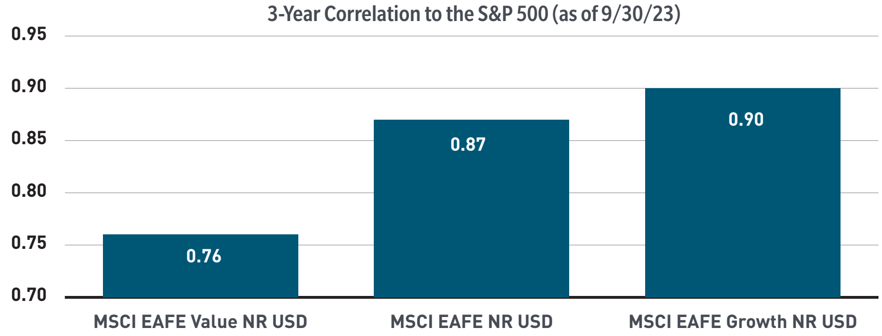
While the connections we've made above between the lead up to the 2000's cycle and today are important, we shouldn't lose sight of the big picture. Going all the way back to 1980, the MSCI EAFE Value Index has outperformed the S&P 500 Index nearly 40% of the time over rolling 5-year periods (Exhibit 3). The most recent stretch of rolling 5-yr US outperformance versus EAFE Value is the longest in the past 40 years; however, we witnessed a similar stretch of US leadership in the 1990's. The point being that this trading of performance is to be expected. Perhaps more importantly, it makes the case that for long-term investors an international value allocation can be a great diversifier to US exposure in an equity portfolio. While the historical benefits of diversification are well known among the investing community, not only does the international value asset class offer more diversification today for US investors, compared with both the international core and international growth asset classes, that level of diversification, when looked at through the lens of correlations, is at or near the widest levels we've witnessed historically (Exhibits 4a and 4b).

### Exhibit 3: MSCI EAFE Value Performance Relative to S&P 500



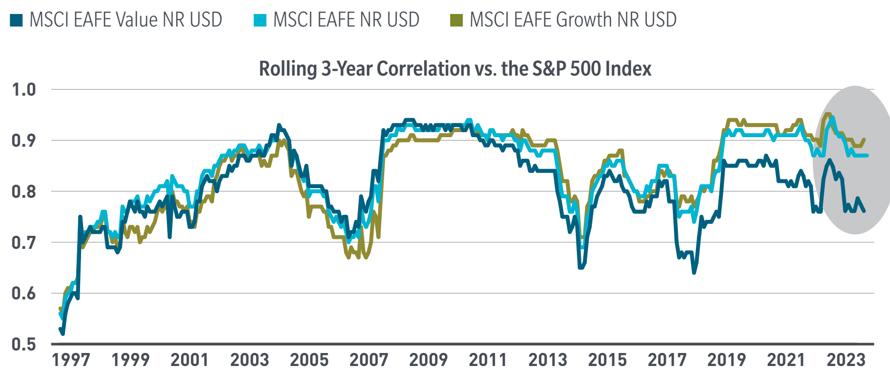

Source: FactSet. Rolling-five-year performance based on annual data as of 1 January 1976 to 31 December 2022.

## Exhibit 4a: International Value offers meaningfully more diversification to US equities relative to both International Core and International Growth




Source: Morningstar Direct, as of 30 September 2023.

## Exhibit 4b: The diversification benefits of International Large Cap Value are near historic highs relative to the past 25 years




Source: FactSet. Three-year correlation based on monthly data as of December 1997 to September 2023.

## Conclusion

While no two periods are perfectly alike, one could draw several similarities between the roughly eight-year period starting in the early 2000s through much of that decade, where international value stocks strongly outperformed their US counterparts, to today's environment. Whether looking at inflation or interest rates, the value of the US dollar, valuation differential or simply the heightened concentration risk in US indices, the similarities are striking. Perhaps more importantly, coming out of a world of zero inflation and zero interest rates where diversification proved a headwind to performance, the outsized diversification benefits of an allocation to the international value asset class, in our opinion, could prove quite valuable to investors over the years to come.

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