Capital Risk

# GLOBAL EQUITY MARKETS

# Relocating Value


Photo: Clay Banks on Unsplash

**An Unwarranted Demise.** Value investors in the U.S. extol the virtues of patience and resolve as their underperformance reaches two decades. For those attentive to the changing world around them, the tail told for the demise of value investing is incoherent with the global reality. Value investing is thriving in the regions where one would expect it: those with high fixed investments. China and other countries that are the goods export engine of the world delivered impressive returns for value investors over the last decade. This outcome is logical because countries that focus on services (e.g., the U.S.) are *increasingly less fixed capital intensive* and thus deliver a *decreasing value factor* exposure. The international value factor is alive and well. *As the global economy evolves, so should investors.*

"

U.S. value investors endured underperformance for two decades. Values acolytes continue to preach patience and resolve to their detriment.

Value investing is alive and well outside of the U.S. Following the global trade patterns for goods for its location is a well-rewarded endeavor.

- Jason Prole

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## Highlights

- **Value** is a function of global trade patterns, so follow the goods.
- **Profits**, the darling of financial analysts, dominates all factors.
- **Size** is remerging because of ample liquidity, not good value.
- **IPOs** signal an extreme in equity valuations, particularly in the U.S.
- **Non-U.S. Developed** markets provide value as the global economy recovers.
- **Staples** and **Communications** offer relative value between sectors.

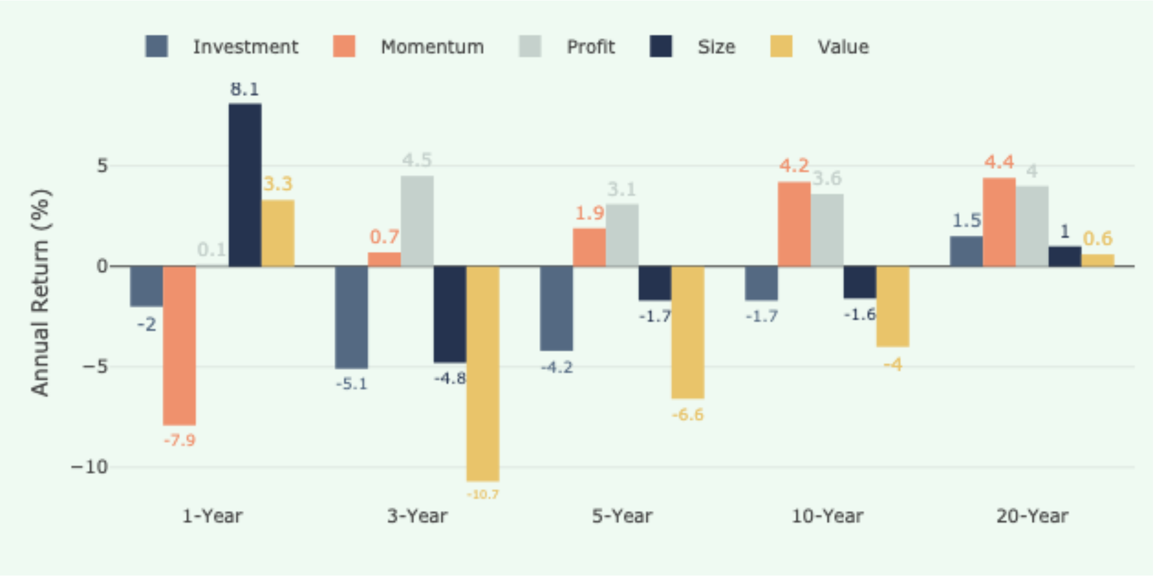
# The Macro View

**Profit Momentum.** The last decade was troublesome for traditional security analysts. The hallmark of fundamental analysis was thrown asunder as value underperformed as a factor in the developed markets (Exhibit 1). The hope for reversion to the mean never occurred, and the value factor has now delivered *two decades of underperformance*. This depressing performance tests the resolve of stalwart value investors. In contrast, investors in the technology monopolies are resplendent in their promised early retirement. Yet, the dichotomy between the two is not evident upon closer inspection.

Profit as a motivating factor for investment is clear. Higher profit growth delivers higher value to the investor. This outcome is dear to all fundamental investors who seek *stable and growing* earnings. The durability of the global technology companies' moats has not been this secure since the heyday of rail in the nineteenth century. The difference this time is that the monopolies are *global* rather than national. Thus, the profit factor has outperformed for *over two decades.* Indeed, for those less inclined to security analysis, following momentum was equally remunerated. It seems that companies with high tangible book values are unrewarded. Yet, this is not entirely truthful.

**The global value factor's demise is evident.**

Exhibit 1. Fama & French Equity Developed Markets Factor Returns




***Source:*** *Kenneth R. French website. Data as of June 2021. CRM Calculations.*

# The Macro View

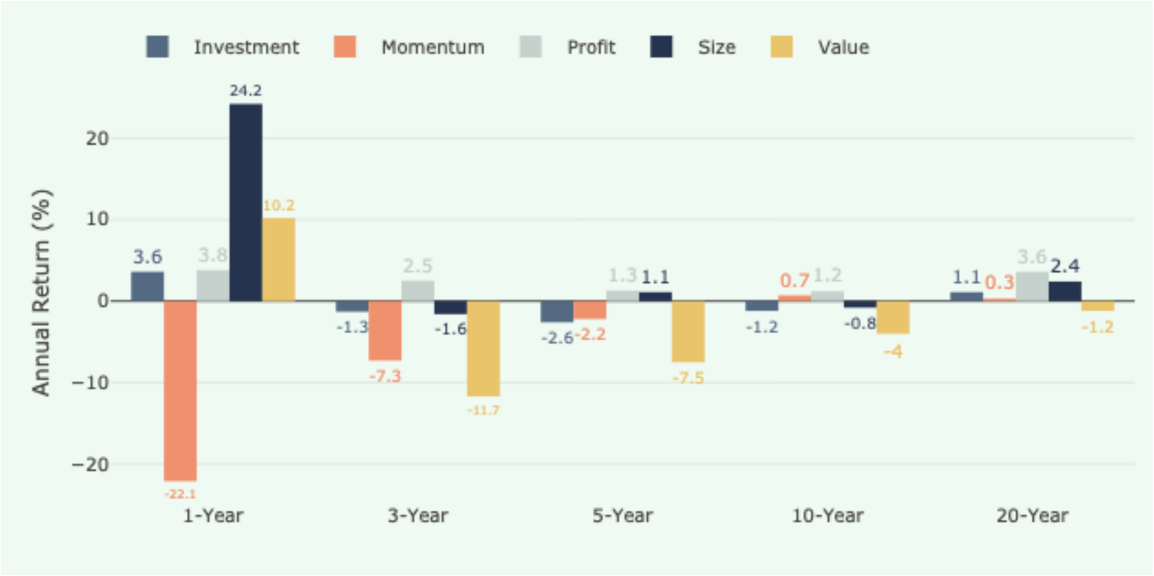
**Location Matters**. While the developed markets enjoyed some reward for their factor exposures, the same is not valid for the dutiful U.S. factor investor. Most factors were not rewards over the last decade, with the profit and momentum factor eking out minor gains (Exhibit 2). The challenge is that it followed a prior decade of trivial returns. Once accounting for the last year's increases, the only significant positive returns belong to the *profit factor*.

The value factor is the most disappointing one in the U.S. as its negative performance *exceeds two decades*. Long-term investors will extol reversion to the mean and patience. Yet, as the time horizon extends into decades, their resolve is supremely tested. The challenge may reside in the generational shift occurring for *who is investing*.

The value renaissance started in the 1970s and endured until the 1990s technology bubble. This outcome is significant because these investors never knew anything but *value as the dominant paradigm*. As the secular trend shifted in the Aughts, they persisted with what made them successful. As globalization and technology's monopolistic practices enabled profits not seen in a century, the value factor followed the *trade patterns and shifted locations*.

**U.S. value investors were not rewarded**

Exhibit 2. Fama & French U.S. Equity Market Factor Returns




***Source:*** *Kenneth R. French website. Data as of June 2021. CRM Calculations.*

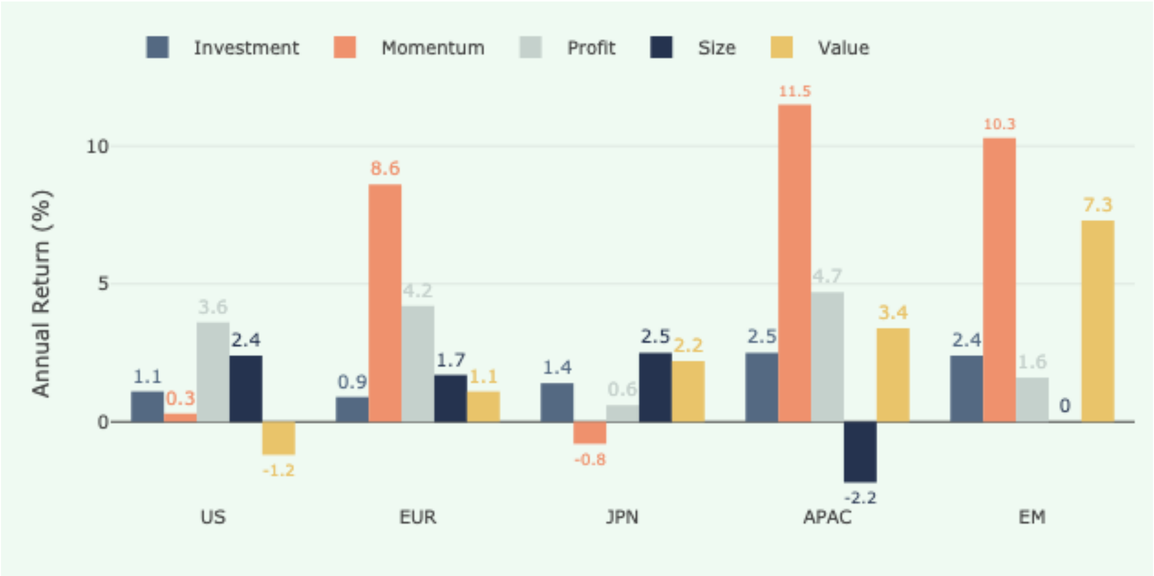
# The Macro View

**Relocating Value.** The entry of China into the World Trade Organization (WTO) in 2001 changed trade and investment dynamics. The high investment rates in China built out infrastructure at a speed that had no contemporary parallels. Eager to remove the burden of fixed costs, U.S. firms outsourced a material component of the manufacturing. The key measure of the value factor, book (i.e., fixed assets), moved as well (Exhibit 3). Investors extol the loss of value in the U.S. yet ignore its success in Asia and the Emerging Markets (and in Europe and Japan) is a startling disconnect.

The U.S. factor market performance leaders are bifurcated into the mega-capitalization technology stocks and the less liquid small-capitalization stocks. The small-cap stock performance is primarily a function of the startling rise in the prices over the last year. This insight leaves profit as the reigning factor in the U.S. (and everywhere). Elsewhere it is the value factor and momentum. The former is not surprising given the change in trade patterns. As for the latter, when small markets face substantial cash inflows, *momentum should dominate*. While Europe in aggregate is large, *each country within it is not*, contributing to the momentum factor. *Value is alive and liquidity matters*.

**Value is alive and well outside of the U.S.**

Exhibit 3. Fama & French Equity Regional Markets Factor 20-Year Returns




***Source***: *Kenneth R. French website. Data as of June 2021. CRM Calculations.*

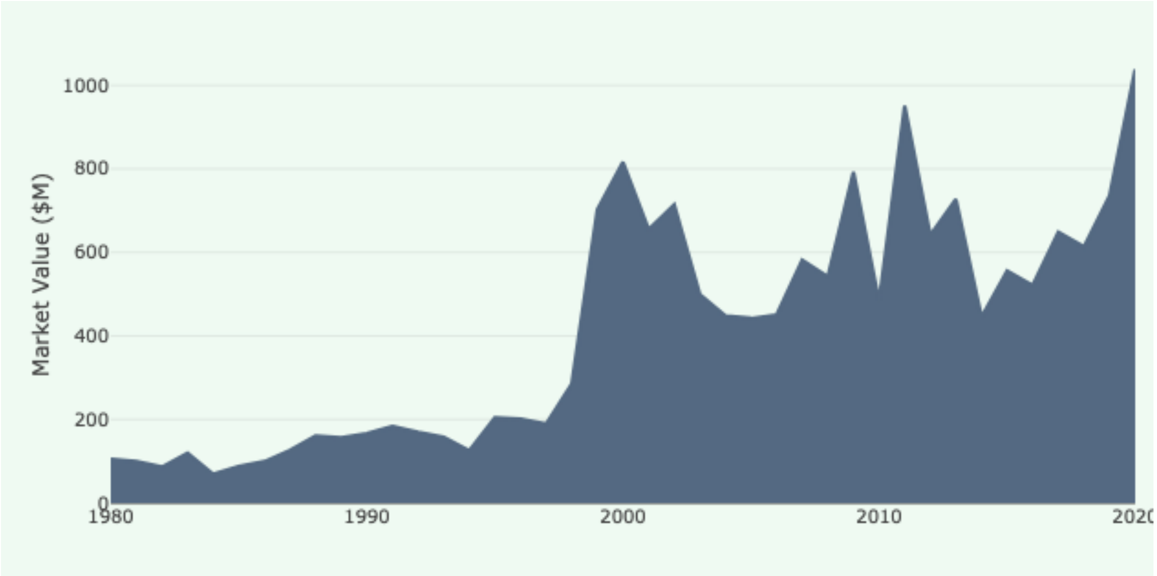
# The Macro View

**Fungible Products**. The success of the U.S. technology companies over the last two decades generated enormous wealth. Investors now clamor to find the next unicorn in hopes of delivering the next 100X investment. This decision has lifted the private equity (PE) and venture capital VC market values to multi-trillion-dollar levels. The end game for them is a public listing. Initial Public Offerings (IPO) median first-day market values are at an all-time high (Exhibit 4). These flows impact the small-cap market *materially*.

The small-cap median market value is about $1.5 billion.[1] Thus, IPOs enter as prime candidates for the small-cap market index. The PE and VC markets are inaccessible to most investors, particularly small public market investors. They must wait for the IPO before accessing these investments. The first problem is that this market is only a twenty-fifth of the size of their larger brethren. This size difference ensures that flows from big to small will deliver an enormous impact, much like the one seen over the last year with the index more than *doubling in value*.

**IPO valuations are at *all-time highs*.**

Exhibit 4. Initial Public Offerings Median Closing Market Value (Constant Dollars)




***Source**: Ritter, Jay R. 2020. Initial Public Offerings: Updated Statistics. Table 4f. Available at: https://site.warrington.ufl.edu/ritter/ipo-data/*

[1] S&P Indices, August 2021. Median constituent market value.

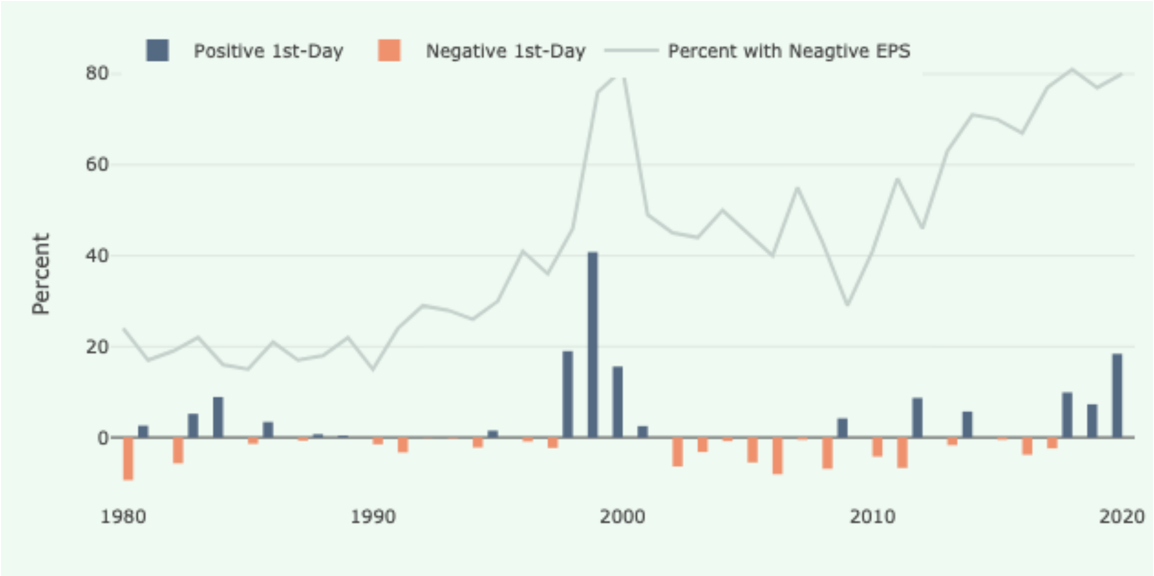
# The Macro View

**Ethereal Value**. Expected *future* profits are a critical determinant of *present* value. This trite statement is the crucial measure of financial analysis. Of course, predicting the market leaders' decades hence is a Herculean task. The investors of Blackberry know that robust profits and a dominant market share don't preclude a quick fall from grace as a new product enters markets (i.e., Apple's iPhone). Yet, critical to these future winners is *current* profits, no matter how meager. Profits are where the *current* problem arises.

Earnings for IPOs are as rare as the unicorns that investors chase (Exhibit 5). In an investment environment where four out of five new listings have negative earnings, the search for value is elusive. IPOs have performed admirably over the last three years on their listing day, with positive gains for the median company. This outcome is despite the empirical evidence that companies without earnings foreshadow poor future returns. Only the Tech Bubble of 2000 exceeds these ethereal numbers.  An investor looking for value should look elsewhere. In contrast, all investors should focus on changes of liquidity, particularly as the third-quarter earnings season approaches. Momentum is two-sided.

**Price gains belie *negative earnings*.**

Exhibit 5. U.S. Initial Public Offerings Percent with Negative Earnings & Initial Returns




***Source***: *Ritter, Jay R. 2020. Initial Public Offerings: Updated Statistics. Available at: https://site.warrington.ufl.edu/ritter/ipo-data/*

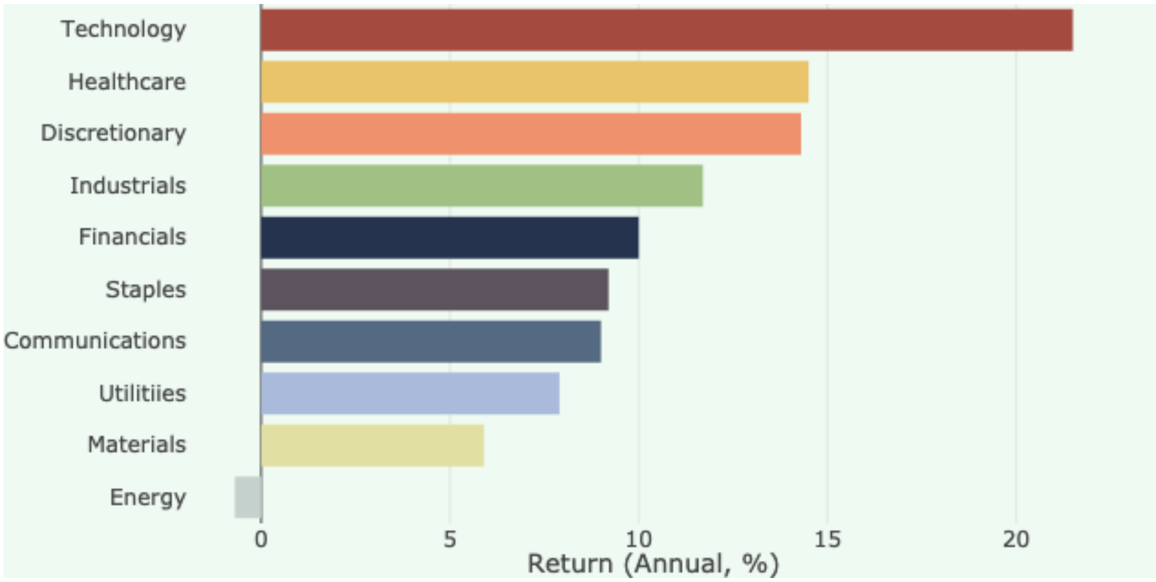
# Equity Markets

Monetary stimulus and investor exuberance continue to lift global equity markets. As with all bull runs, the demise will stem from the realization of the discord between prices and economic reality. The timing and catalyst of this epiphany are uncertain, while the divergence between the favored and despised sectors is material (exhibit 6). The Technology sector delivered over 20% annualized gains, while Energy lost value over the last decade. While each decade has a leader, the gap between the runners-up, Health Care and Discretionary, is over *seven percent*. Indeed, when the game changes, holding fallen angels is not rewarded.

This outcome hides that Energy was the previous decade's darling. While the future is inherently uncertain, finance provides one law as fundamental as gravity is to physics: *reversion to the mean*. The crucial question is whether the infatuation with Technology will endure. There are no simple answers. The quick response is that some combination of competition, innovation, and policy will conspire to realign the sector's dispersion. Until the change is evident, abnormal profits are the mantra for the investor. Investors should hide in the comfort of *current profits* rather than dance with the crowd in hopes of future earnings.

**Reversion to the mean is powerful.**

Exhibit 6. Global Equity Sectors Annualized Returns




***Source***: *IEX Cloud. CRM Calculations. Total returns from August 31st, 2011, to August 31th, 2021.*

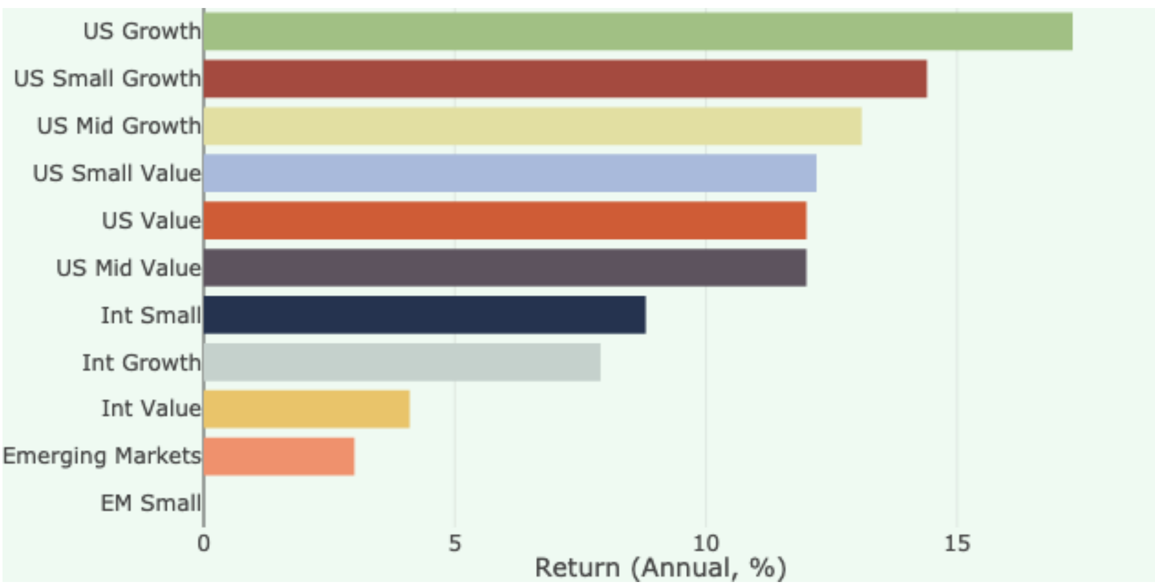
# Equity Markets

**Future Uncertain**. Discerning current profits is easy. Forecasting future profits is a more arduous task. Parsing the global equities by style and size tells an incongruent story as U.S. Growth dominates all styles and regions (Exhibit 7). International Growth delivered half the return of U.S. Growth. In contrast, the Emerging Markets had one-third of the return despite their economic growth doubling that of the U.S. Indeed, ubiquitous Technology knows no borders, enabling higher growth. Yet, this dominance faces threats.

For Growth to endure, their monopolies must be secure. As every value manager preaches, a moat protects earnings. Whether this is patents, technology, or brand is crucial. Only the latter is enduring as the former are subject to *policy decisions*, which investors in China's technology sector know full well. With little further market shares gains available to the technology leaders (e.g., Google and Facebook with Apple, Microsoft, and Amazon as border cases), their future earnings are a function of *global anti-trust legislation*. The trouble for investors is that the recent comparable anti-trust activity, the U.S. versus Microsoft, took a decade to resolve and ended with them still at the top. Indeed, forecasting future profits is challenging, the *timing more so*.

**Growth is the world's darling.**

Exhibit 7. Global Equity Style Annualized Returns




***Source***: *IEX Cloud. CRM Calculations. Total returns from December 31st, 2010, to June 30th, 2021*

# Equity Markets

**Climate Change**. Investors in the U.S. were richly rewarded over the last decade (Exhibit 8). Since the trough in valuation in 2008, the U.S. doubled the other developed markets. This leadership is a function of technology prominence and reserve currency dependence. The latter ensures support for the U.S. dollar and lower non-U.S. market returns, particularly when a secular decline of commodity prices occurs. In a world that is increasingly driven by technology and less by commodities, U.S. leadership endures. Yet, the current challenge is how to leverage technology to ensure commodities impact the environment less. This situation has *profound implications* for future returns.

The U.S. is not necessarily the current leader in the technology that will address climate change. This situation opens the door for a non-U.S. company to disrupt one of the largest markets in the world. Further, a repricing upwards of commodities to reflect their environmental impact would result in a de factor *devaluation of the U.S. dollar*. Their combination suggests that U.S. technology dominance and *investment leadership* over the next decade is not a foregone conclusion. While a resurgence of *brown* energy is unlikely (e.g., fossil fuels), *green* energy is vital to the environment and *future investment*.

**U.S. equity leadership continues.**

Exhibit 8. Global Equities Relative Performance of U.S./International


***Source***: *IEX Cloud. ITOT & EFA total returns. Ratio increases reflect US outperformance.*

# Equity Markets

**Green Gold.** Texas was infamous for its *black gold* in the early twentieth century as crude oil provided the energy for the industrial and automotive revolutions. The next renaissance will deliver *green gold* from alternative energy that does not pollute the environment. This outcome is crucial in a world increasingly dependent upon computer technology, a voracious devourer of energy. While the U.S. supplied consumer -acing technology that changed the world in the last two decades, Europe and Japan are further along implementing clean energy.

This technology and implementation leadership for alternative energy in Europe may provide an avenue for their growth leadership to endure (Exhibit 9). A critical determinant of whether growth leads value will be whether the value proposition is a function of fixed assets or margin expansion. If the value proposition is a function of high fixed costs as new means of generating electricity are deployed, then a value resurgence is probable. Alternatively, if services better utilizing electricity consumption are the driver, then growth may dominate. The investor confronts the complex challenge of *forecasting the future winners* for a complex and global energy problem. Today's leaders may be tomorrow's laggards.

**The future of Value and Growth resides in new energy.**

Exhibit 9. International Equities Relative Performance by Style (Growth/Value)


***Source***: *IEX Cloud. EFG & EFV total returns. Ratio increases reflect growth outperformance.*

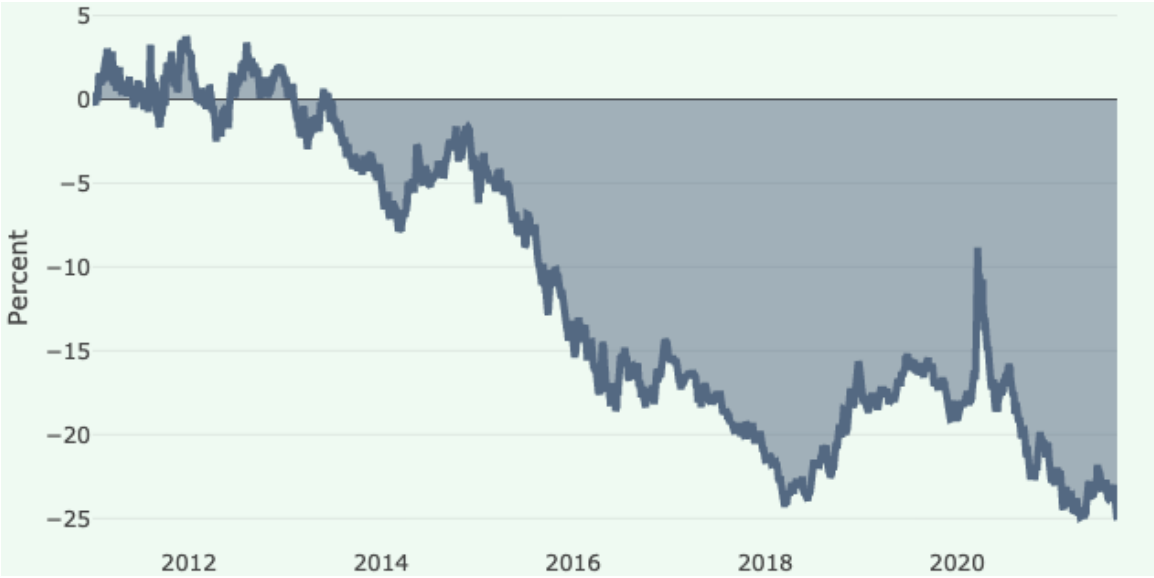
# Equity Markets

**Size Matters.** Capital is still supporting the International Small-cap equities versus their larger peers (Exhibit 10). One of the drivers of this outcome is their more extensive breadth (i.e., over 6,000 companies) and their smaller size (i.e., ~$800MM). This situation enables capital flows to impact their pricing materially. While there is uncertainty to the permanence of their strength versus their larger peers, their breadth and nimbleness provide an avenue to deliver the technology that can address climate change. Randomness requires large numbers to produce an unlikely outcome: international equities offer this dimension.

The challenge for small-cap stocks is that the climate challenge is massive in scale. Ideas require the capacity to implement, which is where larger firms may have the advantage in their more ready access to capital and suppliers. Of course, large companies can buy the smaller ones with compelling technologies. The result would be small-cap outperformance versus large. As always, the investor faces the hurdle of forecasting an uncertain future. Thus, an investor should play the odds: the chances are higher in diversified small-cap stocks than in large-cap.

**Small stocks provide the opportunity for disruption.**

Exhibit 10. International Equities Relative Performance by Size (Large/Small)




***Source***: *IEX Cloud. EFA & SCZ total returns. Ratio increases reflect large outperformance.*

# Equity Markets

**An Unequal Balance.** The choice between the Emerging Markets (EM) and developed markets ex-U.S. appears an easy option. The larger populations and higher productivity gains suggest the Emerging Markets. Yet, over the last eight years, they delivered similar returns (Exhibit 11). The choice is effectively between the greater numbers in Emerging Markets and the technology leadership in the Developed Markets. Yet, the latter is debatable given China's technology titans and the strategic goals of dominating clean energy technology. Policy may trump productivity in the Emerging Markets.

Indeed, there is no more pressing concern than climate change. The impact on some Emerging Markets will be severe as higher oceans may make whole countries disappear. Nothing can compel people to act more than an existential challenge. Both China and India face compelling incentives to address climate change sooner rather than later. This urgency may result in frantic activity to resolve their challenges. A large, educated populous permits randomness to deliver a solution. As the U.S. showed during the 1940s, a compelling industrial policy can provide many solutions during times of crisis.  Whether people, productivity, or policy reigns, only the future can tell. Investors should manage their portfolios accordingly.

**Climate change will determine future growth.**

Exhibit 11. Global Equities Performance of International/Emerging Markets

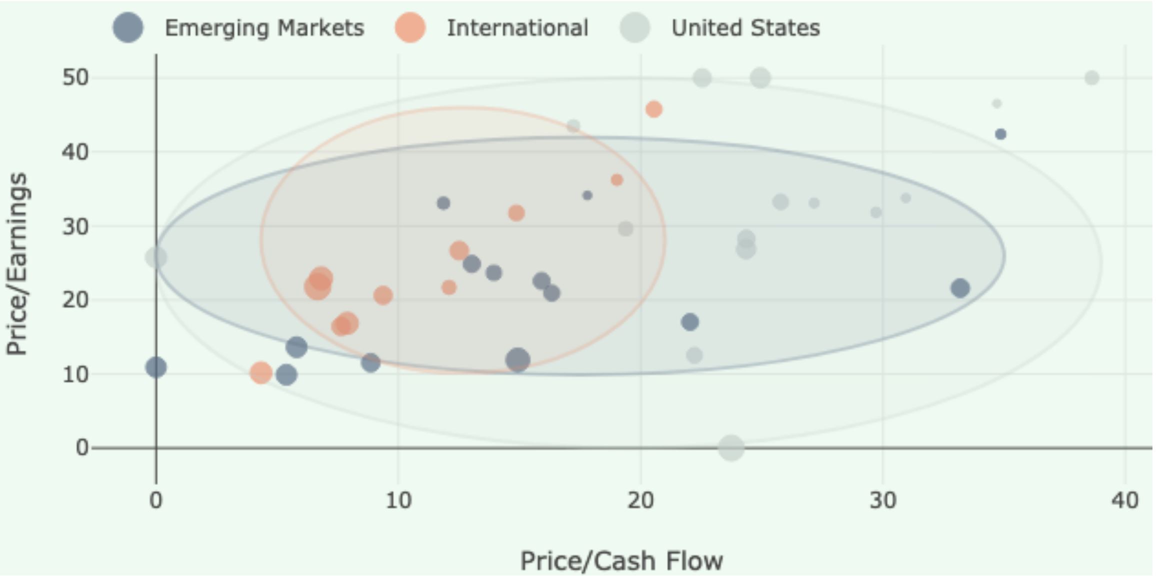

***Source***: *IEX Cloud. EFA & EEM total returns. Ratio increases reflect US outperformance.*

# Equity Markets

**Unequal Dispersion.** Valuation variations permit tactical portfolio positioning. In this regard, the global markets have ample opportunity across and within regions. Dispersion is high within the U.S. and Emerging Markets while less so for International markets (Exhibit 12). The most notable divergence between regions is the universally higher valuations for U.S. sectors and styles. These higher multiples suggest either higher U.S. cash flow growth or that repatriated foreign earnings expand faster. These are unlikely at current levels. This outcome provides the highest conviction decision for allocators: *underweight U.S. equities* versus the other regions, particularly International equities.

**Regional dispersion provides opportunity.**

Exhibit 12. Global Equity Valuations by Region and Sector




***Source***: *S&P Indices. Size of the marker reflects the dividend yield (larger is higher). Valuation is limited to zero and fifty for ease of exposition. As of August 2021.*

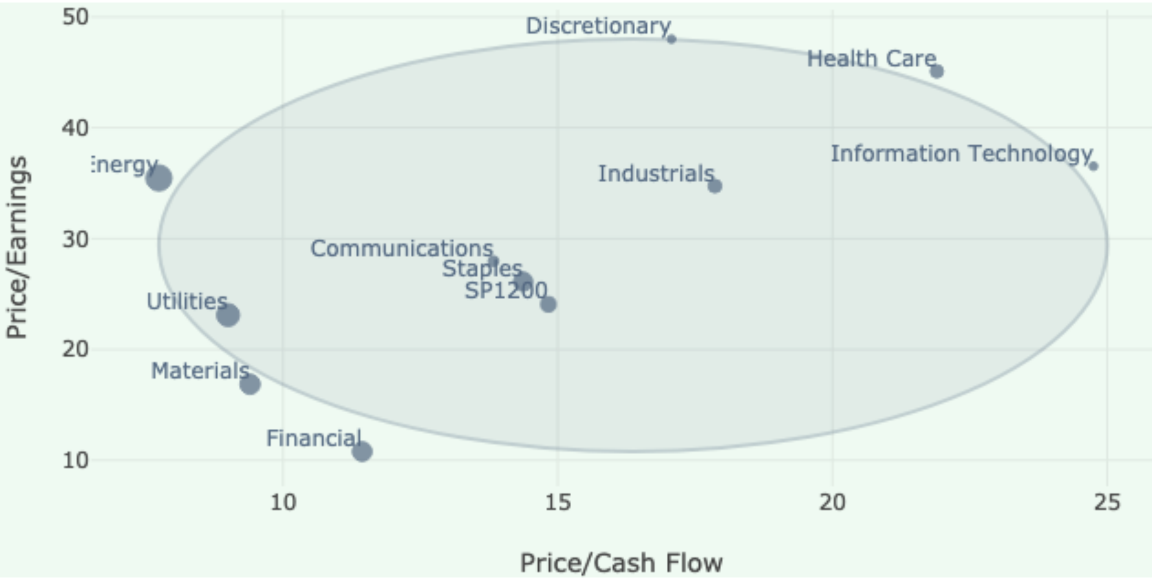
International markets provide consistent valuations regardless of the measure (e.g., Piece/Earnings or Price/Cash Flow). This data artifact suggests that the measurement does not distort the region. In contrast, the other region faces wide cash flow dispersion (i.e., Emerging Markets) or earnings variation (e.g., U.S.). The investor faces the challenge of *choosing either* the region or the valuation measure.

# Equity Markets

**Mean Aversion.** That investors chase the hot sectors is not a surprise. The current hot sectors include the obvious during recovery from a pandemic, Health Care & Discretionary, and those that entice the Millennials, Information Technology (Exhibit 13). Their valuations are extreme regardless of the measure while also offering low dividend yields. Of course, they may grow into to their valuations. Yet, those betting on the Health Care and Discretionary sectors may find disappointment as the Pandemic passes.

**Sector variation provides opportunity.**

Exhibit 13. Global Equity Valuations by Sector




***Source***: *S&P Indices. Valuation limited to zero and fifty for ease of exposition. As of August 2021.*

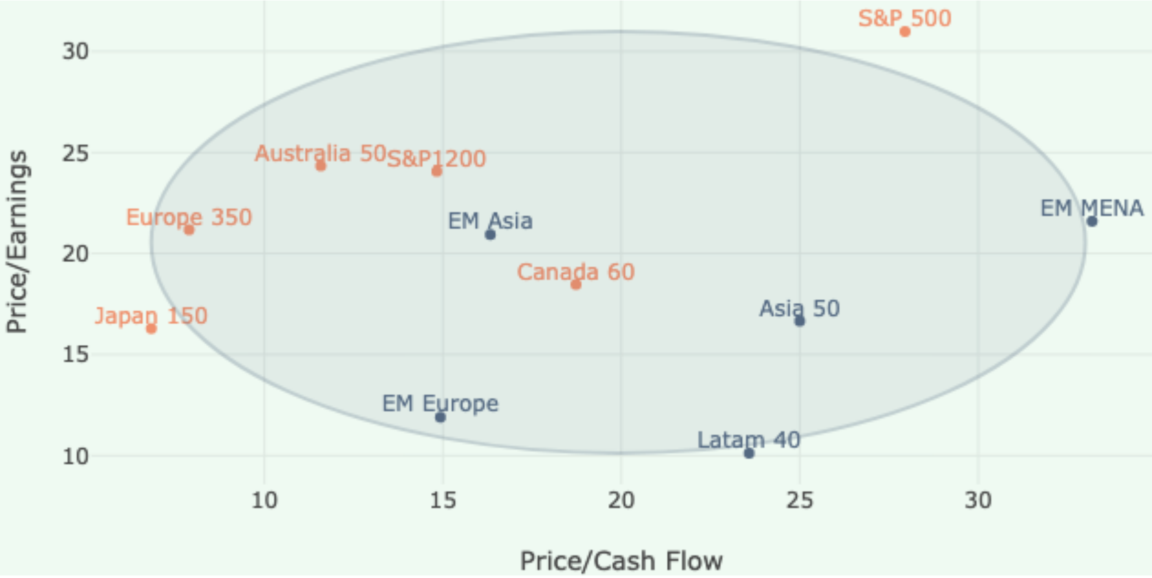
As the Pandemic recedes from view, other sectors will emerge. The advances in technology suggest that Communication may receive a boost. At the same time, Staples will benefit from the Millennial generation entering their prime household formation years, which was postponed during the Pandemic. In contrast, the Financial and Energy sectors are well valued yet face uncertain prospects. The former is due to uncertainty as monetary and fiscal stimulus fade. The latter is from the transition to a cleaner energy future. As these tactical themes unfold, *managing portfolio risk* through tactical asset allocation or stock selection is critical. Active management takes *compensated risks.*

# Equity Markets

**Cash Earnings**. The variable response to the Pandemic is an issue for the short-run as different regions exit the Pandemic. An investor's focus belongs to the long-term. The current dispersion in valuation measures across countries provides an opportunity (Exhibit 14). The divergence between developed and emerging markets is apparent. The U.S. and oil-based economies show the most extreme measures. Critically, the difference is between measures of flow and earnings. As acolytes of business schools learn, a business's ability to *generate cash* is crucial.

**Follow the cash for valuation.**

Exhibit 14. Global Equity Valuations by Region

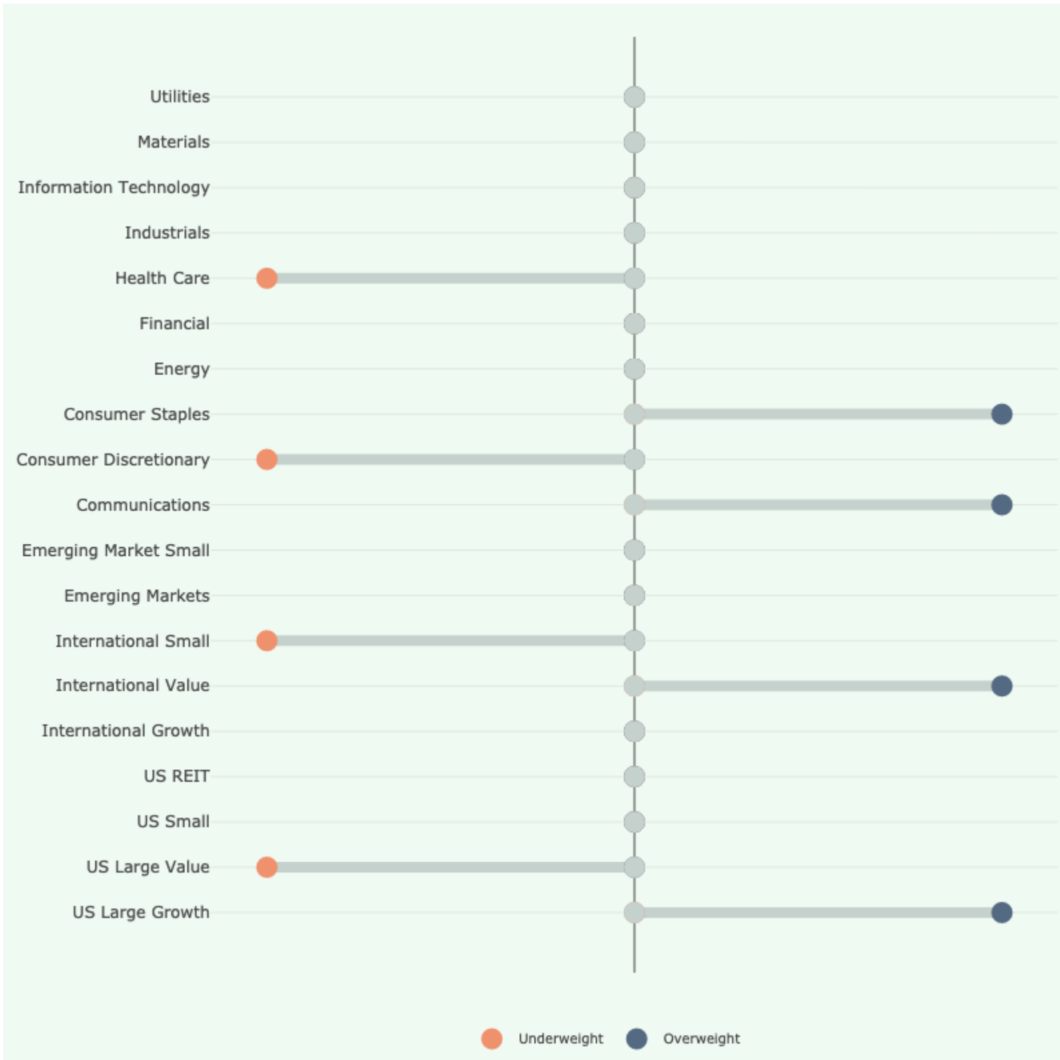



***Source***: *S&P Indices. Valuation limited to zero and sixty for ease of exposition. As of June 2021.*

Between the Developed and Emerging Markets, the choice appears for the non-U.S. developed markets. While within the Emerging Markets, the case is strong for Europe and Asia. Japan and EM Asia offer reasonable valuations attached to a global export engine primed for a worldwide economic rebound. Their European counterparts could also play a role a country-specific basis. The U.S. investor's challenge is managing the currency exposure. Thus, *portfolio design* is critical to success in this divergent investing landscape, whether investing in *factors, regions, or countries*.

## Exhibit A1. Tactical Asset Allocation Positioning

*Six-to 18-month asset allocation perspective*




*Note: Positioning is indicative of the themes discussed in this report and valid as of the report date. Views are subject to change. These statements are forward-looking, and there are no assurances that such events will transpire. The positioning does not reflect actual positions and does not consider an investor's objectives, risk preferences, or their current asset allocation. Seek professional advice when undertaking any investment program.*

Exhibit A2. Asset Class Performance

| Sector | ETF | QTD | YTD | One-Year | Three-Year | Five-Year |
|---|---|---|---|---|---|---|
| **Global Equity** | ACWI | 3.1 | 15.8 | 36.3 | 14.7 | 14.6 |
| **Global Equity xUS** | ACWX | -0.2 | 9.3 | 30.1 | 8.3 | 9.9 |
| **US Total Market** | ITOT | 4.7 | 20.6 | 42.8 | 19.2 | 18.0 |
| **US Large Cap** | IVV | 5.5 | 21.6 | 40.5 | 19.3 | 18.0 |
| **US Growth** | IUSG | 7.8 | 23.2 | 42.9 | 24.2 | 22.2 |
| **US Value** | IUSV | 2.5 | 19.6 | 39.3 | 12.5 | 12.5 |
| **US Mid** | IJH | 2.4 | 20.3 | 49.9 | 13.3 | 13.8 |
| **US Mid Growth** | IJK | 2.3 | 14.9 | 40.1 | 14.3 | 14.5 |
| **US Mid Value** | IJJ | 2.2 | 25.6 | 60.3 | 11.3 | 12.2 |
| **US Small** | IJR | -0.5 | 22.9 | 59.7 | 10.8 | 14.5 |
| **US Small Growth** | IJT | 1.9 | 18.6 | 51.8 | 12.3 | 16.0 |
| **US Small Value** | IJS | -2.6 | 27.0 | 68.1 | 8.7 | 12.5 |
| **US REIT** | USRT | 6.7 | 30.2 | 41.4 | 12.2 | 7.1 |
| **International** | EFA | 2.2 | 12.0 | 33.0 | 8.3 | 9.8 |
| **Int Growth** | EFG | 3.7 | 11.2 | 30.3 | 12.9 | 12.1 |
| **Int Value** | EFV | 0.4 | 11.9 | 34.2 | 2.9 | 6.8 |
| **Int Small** | SCZ | 4.6 | 14.5 | 43.3 | 9.7 | 11.7 |
| **Emerging Markets** | EEM | -5.0 | 1.9 | 22.9 | 7.6 | 9.9 |
| **EM Small** | EEMS | -1.1 | 18.1 | 49.6 | 11.1 | 10.3 |

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