Strategic Global Advisors®

Rethinking Conventional Wisdom in a Shifting Investment Landscape

Brett Gallagher & your team at SGA

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Introduction

One of the most important tasks for those who oversee retirement plans or other pools of investor monies is getting the asset allocation correct – e.g., how the pool should be spread across stocks, bonds, real estate, infrastructure, commodities, etc.

Only slightly less important is the allocation within each asset class – U.S. vs. International, Developed vs. Emerging, Large vs. Small, High Quality vs. Junk, etc. Conventional wisdom has long been that the best place to start is with a broadly diversified set of assets and geographies.

However, one can be forgiven if they feel such convention is passé. Indeed, since the end of the Global Financial crisis (through December 2023), U.S. equities have handily outperformed their international peers – in 11 out of 14 years and overall by more than 7% per year. For a $100 million pool, that's the difference between having $292 million or $552 million on hand at the end of the period.

– See Figure 1 on the following page –

IN THIS PAPER

- Historically wide P/E discounts and dividend premiums bode well for the relative performance of EAFE equities in the years to come.
- The debt maturity profile of the U.S. is problematic given its extremely short-term term composition. One-third of U.S. debt will mature in the coming year, subject to higher refinancing rates.
- Interest expense as a percent of tax revenues collected will soon approach and exceed 50% – a level only seen one time before.

Figure 1: MSCI EAFE vs. MSCI USA Annual Returns

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
USA 14.77%	USA 1.36%	EAFE 17.32%	USA 31.79%	USA 12.69%	USA 0.69%	USA 10.89%	EAFE 25.03%	USA (5.04%)	USA 30.88%	USA 20.73%	USA 26.45%	EAFE (14.45%)	USA 26.49%
EAFE 7.75%	EAFE (12.14%)	USA 15.33%	EAFE 22.78%	EAFE (4.90%)	EAFE (0.81%)	EAFE 1.00%	USA 21.19%	EAFE (13.79%)	EAFE 22.01%	EAFE 7.82%	EAFE 11.26%	USA (19.85%)	EAFE 18.24%

Source: MSCI EAFE and MSCI USA index total return, net dividends; MSCI, FactSet

That is a stark difference, but looking backward is easy, whilst our job is to look forward. So the question remains whether conventional wisdom should be ignored yet again? Will the past be prologue?

In an attempt to provide some guidance, it helps to understand where the U.S. advantage came from and assess whether those advantages are likely to persist. For this analysis, we look specifically at the more recent years, using December 2015 as our starting point.

Similar to the full period listed in Figure 1, the MSCI USA Index ("USA") handily outperformed the MSCI EAFE Index ("EAFE") from December 2015 – December 2023, more than doubling the EAFE return – 12.61% vs. 6.15% compounded annually. Which raises another question: Are U.S. companies just that much better or is something else at work? To find out, deconstructing the returns is a good place to start.

Deconstructing Returns

In our view, in order to understand equity returns, one need only know (or be able to forecast) three things:

1. Beginning and ending Earnings per Share (i.e., EPS Growth).
    a. Changes in tax rate will account for the difference between pre and post-tax growth.
2. Investor Sentiment, expressed as the multiple investors are willing to pay for each $1 of earnings generated.
3. Dividends paid and reinvested during the holding period.

Two of the three inputs above are fundamentally based (dividends and EPS growth), while the third, the P/E ratio, is an expression of investor sentiment at a moment in time and can be quite volatile.

MSCI USA outperformance driven by non-fundamental factors and less likely to repeat.

Figure 2: The Report Card

Dec 2015 – Dec 2023	Total Return (Annualized)	Return Due To:			
		Sentiment (P/E Change)	Pre-Tax EPS Growth	Tax Effect (Pre to Post Tax EPS)	Dividends
MSCI EAFE Return	6.15%	-2.95%	6.24%	0.08%	2.79%
MSCI USA Return	12.61%	4.21%	5.68%	1.30%	1.42%

Source: SGA Research, MSCI data, FactSet, Bloomgerg

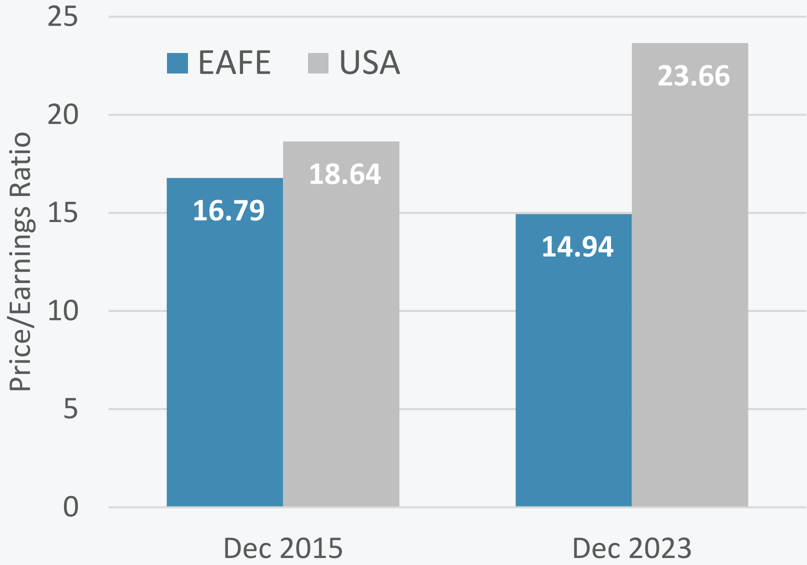
While the USA index more than doubled the EAFE return over the period, most of the outperformance accrued to non-fundamentally driven factors and are therefore less likely to repeat.

Historically wide P/E discounts and dividend premiums bode well for the relative performance of EAFE equities in the years to come.

Firstly, over one-third of the USA index return came simply from the fact that investors were willing to increase the multiple they paid on each $1 of earnings, while simultaneously reducing the multiple they were willing to pay for $1 of EAFE earnings. This sentiment change added 4.21% annually to the USA index return and detracted 2.95% annually from the EAFE index return.

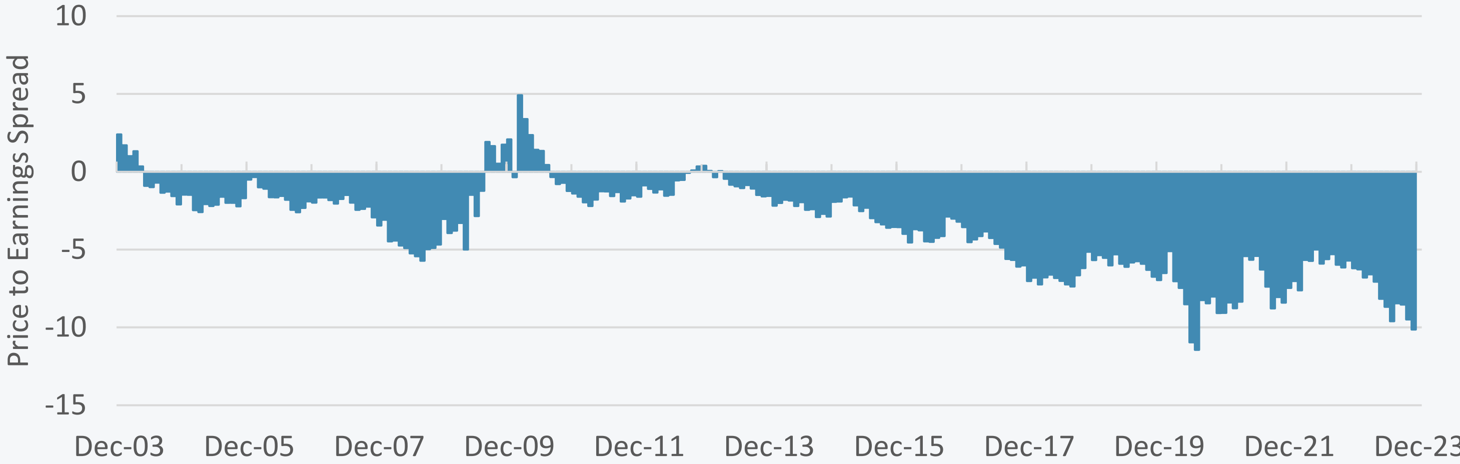
Specifically, the USA index multiple increased from 18.64x (already a bit above the USA index historic average near 17x) to 23.66x while the EAFE index multiple decreased from 16.79x to 14.94x (now close to the long-term average). Today, that P/E ratio gap represents a near record gap in favor of EAFE (99th percentile reading, exceeded only in the midst of COVID).

Figure 3: Price/Earnings Comparison Over Time



Source: SGA Research, MSCI, Bloomberg

Figure 4: Comparative Valuations
MSCI EAFE - MSCI USA Price to Earnings Spread

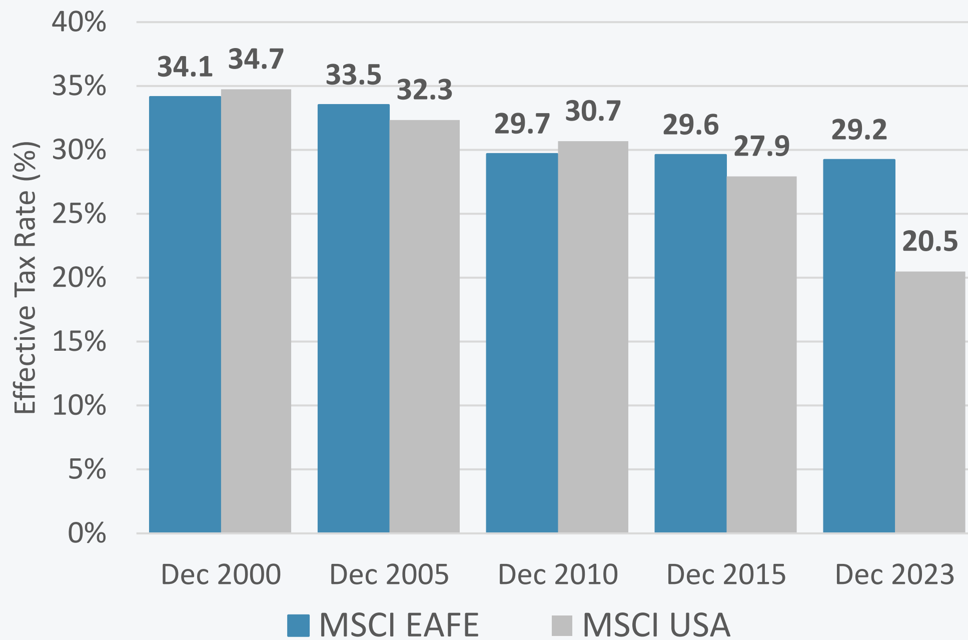


Source: SGA Research, MSCI, FactSet
Calculated using monthly last twelve months ("LTM") Price to Earnings from December 31, 2003 to December 31, 2023.
MSCI USA – MSCI EAFE P/E LTM Spread is calculated as the P/E LTM of the MSCI USA index minus the P/E LTM of the MSCI EAFE index.

EPS growth was stronger in the USA, the entire difference was due to the fact that U.S. effective tax rates fell.

And while after tax EPS growth was stronger in the USA index over the full period (6.97% versus 6.31%), the entire difference was due to the fact that U.S. effective tax rates fell. The Tax Cut and Jobs Act of 2017 lowered the top statutory corporate tax rate from 35% to 21%, resulting in the effective rate falling from 27.9% to 20.5% while international peers saw no relief (their 2015 effective tax rate of 29.6% falling only slightly to 29.2%). Taking away the "tax gift", EAFE companies grew their EPS faster than their U.S. peers over the past eight years (6.24% versus 5.68%, respectively).

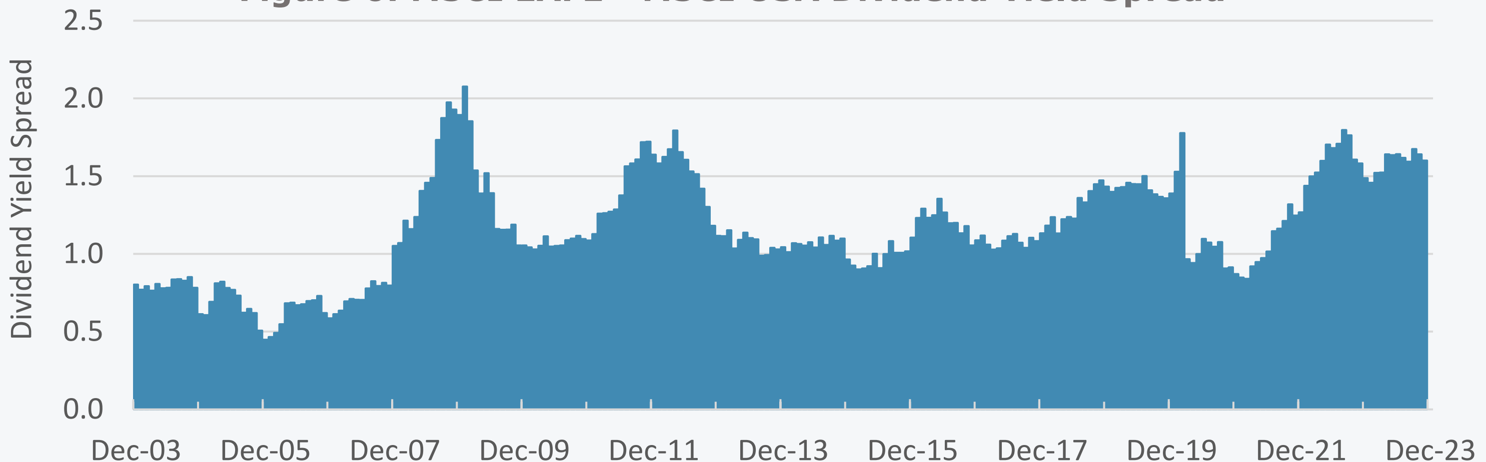
Figure 5: Effective Tax Rate



Source: SGA Research, MSCI, FactSet

The final component of the index returns were the dividends paid and reinvested. Here the EAFE constituents have long held the edge. Over the period from 2015, EAFE constituent dividends contributed 2.79% annually to the overall return versus only 1.42% from USA index members. Currently, the dividend yield gap remains wide, favoring EAFE by 1.60% (3.04% to 1.44%) and providing a comfortable cushion to future returns.

Figure 6: MSCI EAFE - MSCI USA Dividend Yield Spread



Source: SGA Research, MSCI, FactSet
Calculated using monthly last twelve months ("LTM") Dividend Yield from December 31, 2003 to December 31, 2023.
MSCI USA – MSCI EAFE Div Yld LTM Spread is calculated as the Dividend Yield LTM of the MSCI USA index minus the Dividend Yield LTM of the MSCI EAFE index.

The Verdict

In neither of the fundamental measures (EPS Growth or Dividends) were USA index members superior to their EAFE peers. The 2x return advantage came entirely from investor's increasingly favorable sentiment to the U.S. and to a lesser degree, the change in U.S. tax policy.

The Future

Looking forward, the near-record EAFE P/E discount (approximately 37%), and significantly higher dividend yield (3.04% versus 1.44%) leads us to favor non-U.S. developed markets in the coming decade, absent significantly stronger growth from U.S. shares – a situation we assess as low probability.

On the growth front, we expect the U.S. tax tailwind to end (if not reverse), and we see some storm clouds gathering that may adversely impact domestic growth rates.

These clouds relate to United States Federal budget issues and its balance sheet composition where the U.S. has, by far, the most sensitivity to changing interest rates of any of the G-7 countries due to the ultra-short maturity composition of its debt.

While this sensitivity was a benefit when interest rates fell and the country could roll over a significant portion of outstanding debt at ever-lower rates, now that rates are rising, the opposite dynamic prevails. With one-third of outstanding U.S. Federal debt maturing in 2024 (and no other country close), the U.S. will face the strongest headwind of its G-7 peers. Refinancing will take place at today's higher market rates and will raise the annual interest expense quickly.

Figure 7: G7 Sovereign Debt Distribution

		% of Outstanding Debt Maturity in the Given Year				
	Wtd Avg Maturity (yrs)	2024	2025	2026	2027 - 36	2037 +
U.S.	6.20	32.6%	11.6%	8.5%	28.8%	18.4%
Canada	7.50	15.4%	17.1%	10.4%	41.0%	16.1%
Italy	7.00	15.6%	10.8%	10.6%	46.8%	16.3%
Germany	7.33	18.0%	10.8%	6.7%	46.0%	18.5%
France	8.41	12.7%	9.0%	10.2%	48.7%	19.4%
Japan	9.49	9.7%	11.6%	7.7%	43.7%	27.4%
U.K.	14.24	5.7%	8.6%	5.5%	36.4%	43.7%

Source: SGA Research, Bloomberg Data

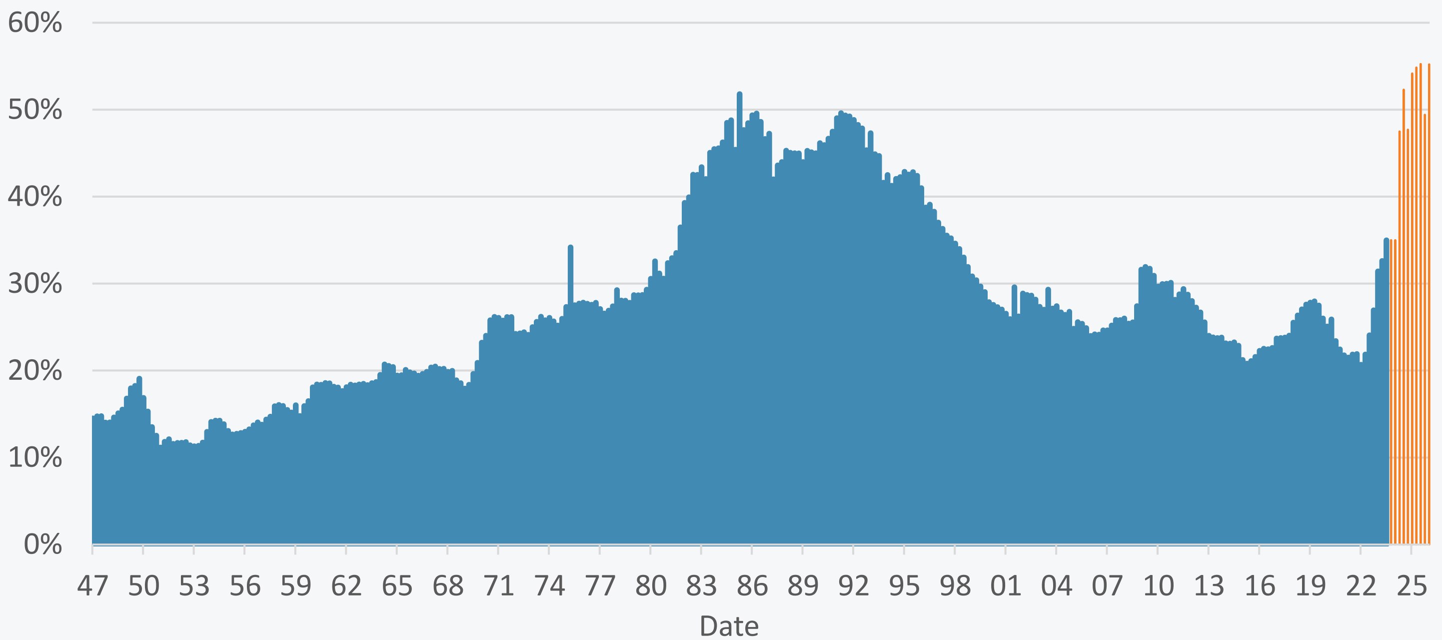
The debt maturity profile of the U.S. is problematic given its extremely short-term term composition. One-third of U.S. debt will mature in the coming year, subject to higher refinancing rates.

Interest expense as a percent of tax revenues collected will soon approach and exceed 50% – a level only seen one time before.

The re-pricing short-term U.S. Federal debt at today's higher interest rates will have interest expenses consume nearly 50% of overall tax revenues before year end. The only other time we have seen anything like this was the early 1980's which resulted in Paul Volker's (there-to-fore) "extreme" rate policies.

With interest expense again approaching the 50% of receipts level, the country's ability to invest in growth-generating initiatives becomes limited and the pressure to raise tax rates increases. The pressure to "do something" is fast approaching.

Figure 8: U.S. Federal Interest Expense as Percentage of Taxes Collected



As of July 31, 2023
Source: SGA; FRED Data, St Louis Federal Reserve

Important Disclosures

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For additional information, please contact Strategic Global Advisors, LLC.

Contact Strategic Global Advisors

Get in touch with our team to learn how you can access the international markets with our distinct integrated approach

Company Headquarters

100 Bayview Circle, Suite 650
Newport Beach, CA 92660
Tel: (949) 706-2640
www.sgadvisors.com

Brett Gallagher
President

Mr. Gallagher is President of SGA. Prior to joining the firm, he was a partner and served as Director of Research and Acquisition at Nile Capital Group, a Los Angeles-based private equity firm. Previously, he served as Deputy CIO at Artio Global Investors/Julius Baer Investment Management, Head of Investment Management Asia for JP Morgan Private Bank in Singapore, and Head of Global Equity for Bankers Trust International Private Bank. Mr. Gallagher has appeared numerous times on CNBC, Bloomberg, and Fox Business News as well as having been quoted in The Wall Street Journal. He was also a guest lecturer at Yale University. Mr. Gallagher received his BA in Economics from the University of Virginia and his MBA from The Darden Graduate School of Business. He is currently a member of the Board of Managers and Chair of the Investment Committee for the University of Virginia Alumni Association.