Get Your Capital a Passport: Traveling Beyond the US to Invest

September 2022

We are often asked by prospective investors whether they should invest capital outside of the United States or if it is good enough to just gain global exposure through US companies. The US has a plethora of industry-leading companies, some of the strongest regulation and transparency globally, and by far the world's largest and deepest capital markets. Additionally, many of the companies based in the US and listed on US exchanges are multinational corporations that derive large portions of their revenues and earnings from developed and emerging markets around the world. So isn't it a better and simpler method to access international markets through a US-listed multinational corporation subject to more stringent domestic laws and regulations? In short, looking at the world as it is today, we believe the answer is emphatically no.

While certainly simpler, we believe that this approach disadvantages investors in several ways. First, limiting one's opportunity set to just one country – even the country with the largest capital markets globally – may result on the whole in less attractive valuations (as of June of this year the S&P 500 traded at a P/E of 18.0x while the MSCI All-Country World Index ex-US traded at 10.8x[i]) and investment opportunities. Simplistically, if one is looking for bargains in the most well-covered and capital-rich country in the world, we believe that they will be harder to find. Secondly, it also doesn't allow investors to take advantage of the significant diversification benefits of not having all of their investment eggs in one country basket. Finally, while this may be a controversial statement, there are many cases where the "best" company within an industry does not have a headquarters in the US. In fact, there are whole industries and business models that are just not available listed on the US market. Be it natural resources, a business or way of doing business unique to a specific region, a labor pool with specific skills, or just a long-tenured globally recognized brand – there are many reasons why the "best" may be outside of US borders.

Better Prices

The main reason at present for sourcing international exposure by investing in companies outside of the United States is simple: more attractive valuations. The US is the world's largest and most-popular financial market, capturing the majority of investor attention. According to the World Bank, the US accounts for just 24%[ii] of Global GDP, yet it recently represented about 75%[iii] of the assets in US Equity Funds. As a result of this, it is also one of, if not the most, competitive markets for investors looking to invest capital and generate above-average rates of return. We believe that this combination of deep sell-side analyst coverage, plentiful investor capital, and home country bias all result in making it significantly harder to find attractively valued opportunities.

We believe that there is merit in looking where others won't or can't. Having a wider area across which to cast our proverbial net, where there are fewer competing investors, allows us to find opportunities overlooked by others – at valuations that may not reflect the persistent optimism that has been a feature of the US equity markets in recent years. A simple example of this is one of the holdings in our portfolio, Arcos Dorados Holdings, Inc. ("Arco")– the master franchisee for McDonalds in Latin America and the Caribbean. While it has many of the same strong brand assets of the American listed analogue and more attractive long-term growth characteristics, it still trades

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at a significant discount relative to the US-listed company (Arco trades at a P/E multiple of less than half of McDonalds Corp.[iv]). Additionally, while US-listed McDonalds Corp. has a global footprint, the faster-growing segments of that footprint are outweighed by its significantly larger exposure to slower-growing developed markets – such as the US – which substantially dilutes the exposure to other regions. In our opinion Arco is a more attractive prospect for investors even though it is not US domiciled, providing – in our opinion – a similar core business but with a more concentrated exposure to a high-growth region.

Additionally, aside from the prices being potentially more attractive outside of the US, while the US is home to many of what are perceived to be the world's best companies, it certainly does not have a monopoly on them. Many of the world's best businesses are in fact headquartered outside of the US, with business models and brands that have stood the test of time and have existed for many decades in some cases. However, over the past decade the "best" businesses have been more-narrowly defined to be those perceived to have good "quality" (e.g. growth potential, brand names, technological disruption). In our opinion, investors have cared less about the price that they have paid for these businesses, as long as the "quality" was perceived to be there. This has been in context of a long period of low/zero interest rates. Should the environment change to one with some more inflation and higher interest rates, the price paid for things might once again matter, not just the "quality."

Better Portfolios

While international markets, and especially emerging markets, are perceived to be individually more risky and volatile than the US market, there are significant benefits that investors get from allocating part of their portfolios outside of the US. While multinational companies domiciled in the US may have exposure to revenues in varied markets around the world, the US stock market tends to trade in a highly correlated manner – especially in times of exuberance or fear. Investing in stocks listed across multiple different geographies around the world has historically provided diversification benefits to a portfolio. Additionally, a portfolio allocated to a variety of securities around the world, with differing business models, regulatory regimes, and currencies may provide additional diversification benefits.

Looking forward, a significant amount of growth is expected to come from emerging markets, where approximately 85% of the world's population lives and which has some of the strongest demographic characteristics. There are massive transformations occurring in these countries that are creating immense new opportunities as people shift from subsistence to entering the middle class and transition from survival to spending to directly improve their quality of life. While it is likely that many US-listed multinational companies will sell products to these billions of people, it is likely that locally established companies will be the ones that will capture the majority of the opportunity as it develops, despite their relatively discounted valuations. Restricting one's investments to US companies may result in not having companies in the portfolio that will best capture this opportunity.

The events of 2022 have cast a strong light upon the need to secure the world's sources of energy, showing in stark contrast the scarcity value of hard assets. While much attention has been paid to oil and gas in this regard, it is just as true – if not more so – for other natural resources. Many of the natural resources that will be needed to transition the world towards a zero-carbon future, as well as those needed to fuel it in the interim, are in countries outside of the US. While US multinationals

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may have some hand in many of these projects, a US-only portfolio will likely be missing exposure to many of the natural resources located in countries outside of the US.

Akin to the situation of natural resources that may be plentiful or only available in certain geographies, there are also many types of attractive industries and business models that exist exclusively outside of the US (unique businesses such as Saskatchewan Wheat Pool in Canada or ABB Grain in Australia). Artificially limiting one's potential investment universe to just one country could result in missing these businesses wholesale.

Aside from the individual companies that will be missing from a US-only portfolio, it is also worth touching on the recent strength of the US Dollar, which has performed very strongly in recent years, providing a strong headwind for those investing in foreign-denominated securities. While the US Dollar has largely moved in one direction – hitting a two-decade high[v] this month – there are likely diversification benefits to a portfolio that has exposure to a wider array of currencies than just one, blunting any potential dollar underperformance.

Not Without Challenges

While the benefits of investing internationally are many, in our opinion, it can also be fraught with challenges. This is why it may be better for most investors to outsource this portion of the portfolio to an active manager. Regulation and norms vary significantly across markets – what may be acceptable in one market may be frowned upon in another. Knowledge of the regulatory, political, and accounting aspects of every single country one invests in is important. Additionally, investing outside of the US tends to cost more. There are costs to opening and maintaining the accounts across the various countries in which one may seek to invest.

Lastly, in our opinion it is important to look beyond broad indexes and ETFs. What at first glance may be largely believed to be broadly-diversified indices may turn out to be considerably less so the more an investor learns what is contained within an index. One example is the MSCI All-Country World Index, which is a very widely-used global index including both emerging and developed markets and covering 85% of the global investable opportunity set. While perceived as a well-diversified global index, it likely has more US-listed large cap tech companies than most people realize. To wit, of the top ten securities in the index, investors might be surprised to learn that as of August 31, 2022, all but one of the top ten (Taiwan Semiconductor) are US-listed[vi] and seven of the top ten are what we consider to be technology companies. The index, which is capitalization-weighted, reflects what has worked well in recent years, namely US-listed large cap technology companies. In fact, the dominance of these companies in the index has grown significantly, with the Information Technology sector now representing 21.5% of the index[vii] – and this excludes companies that are widely-viewed as tech companies, but are not categorized as such (Amazon, Alphabet, Meta, Tencent, and Tesla, among others). This concentration has been one of the largest drivers of the index's decline thus far in 2022.

In short, gaining exposure to international markets through US-listed companies is a lot like visiting Las Vegas. Yes, you can say that you have been to the Venetian – but you have not wandered along the Grand Canal; you have been to the Luxor – but you have not seen the wonder that is the pyramids; and you may have visited New York, New York – but the view looks quite different from the top of the real Empire State Building. Which is just to say, it is a proxy, but not the real thing. And, in our view, a cheap imitation in many respects except its relatively expensive current valuation.

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[i] Source: Bloomberg

[ii] https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?most_recent_value_desc=true

[iii] https://www.morningstar.com/articles/1065413/you-probably-own-too-much-domestic-equity

[iv] Source: Bloomberg

[v] https://www.cnn.com/2022/09/21/investing/global-markets-dollar-russia-mobilization/index.html

[vi] Source: MSCI.com – as of 8/31/2022

[vii] Source: MSCI.com – as of 8/31/2022

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