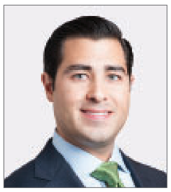
BostonPartners

January 2024

Insights Series | The Setup for Value Abroad

Podcast Transcript



Chris Villalba
Investor Relations

Josh Jones, CFA
Portfolio Manager

Welcome to Boston Partners Insights going beyond the headlines to provide a deeper perspective on the capital markets. I'm Chris Villalba from Boston Partners, Investor Relations Team. Over the last decade, U.S. stocks, driven significantly by the Federal Reserve's zero interest rate policy and dominance of mega-cap stocks, particularly the FANG and now Magnificent Seven, have shown remarkable outperformance compared to international equities. Today, global markets spanning from Asia to the eurozone are navigating challenges posed by inflation, Geopolitical turmoil, including the ongoing conflict in Ukraine and Israel, and various macroeconomic forces, are creating ripples for investors worldwide. In this edition of Boston Partners Insights, we explore international equities, examining the landscape for value beyond domestic borders, and identifying opportunities for active managers. I'm pleased to have Josh Jones with me today, a seasoned portfolio manager at Boston Partners based in our London office. With 18 years of his 20 year career spent at the firm, Josh brings a wealth of experience and a unique perspective on international stocks as he manages our International Equity and Global Long/Short Equity strategies. Josh, welcome.

Josh Jones: Thanks, Chris. Thanks for having me.

C.V. | Josh I think we should start by framing our discussion with a recap of what went on here in the U.S. in 2023. We're sitting here today in mid-December, you had a bank failure crisis that was essentially averted. Inflation and energy are going in a better direction. You had the rise of AI fueling growth in some of the mega-cap magnificent seven stocks. So, let's paint a picture for our audience of where the market has brought us today.

J.J. | When I look at the U.S. market, I mean, obviously the last ten plus years has been really good for growth and kind of the mega-cap stocks, as you alluded to. The line in the sand that I kind of draw was late '21 when inflation really accelerated and the central banks had to effectively start rapidly withdrawing liquidity to slow inflation, and that originally precipitated a negative reaction to the mega-cap stocks. They underperformed quite significantly in 2022, but that ultimately bottomed and we've seen a rebound. Now, when you analyze that, you know, typically after big bull markets like we've had, as soon as you get some kind of indication that maybe for the reason that those stocks have pulled back, the market tends to go back to last cycles winners. So in 2010, 2011, the market tried to run back into commodities because that's what worked from 2000 to 2008 after the GFC. So I think as soon as the market basically saw that inflation was slowing, that potentially the rate increases were peaking, the markets gravitated back into mega-cap stocks. There are some nuances that maybe are a little bit too in-depth for getting into now, but there's liquidity drivers that have basically aided that. Now when I look at those liquidity drivers, to me they're going to continue through about February or March, then they look like they're going to flip rapidly negative. So we'll kind of test the durability of this FAANG bouts, the mega-cap or the Magnificent Seven, I guess as we're calling it, I would say after March.

C.V. | We're sitting here, year's about to wrap up. The S&P is up 22% year to date. Why are we talking about international value right now?

J.J. | One of the things that surprises people, you get on with asset allocators and say, look, your best asset allocation in 2023 has actually been international value compared with basically the Magnificent Seven. So the U.S. market's been driven by seven stocks and up 22%, but international values up 17%. So you're looking at pretty decent returns, particularly compared to U.S. value. So unless you believe that there should only be seven stocks in your portfolio and I would advocate for some level of diversification, you know, values working outside the U.S.

C.V. | What are some of the performance drivers that you've seen outside of the U.S. market year to date?

J.J. | Yeah, there's a few. I mean, generally speaking, what's worked this year was what hadn't worked last year. So consumer, some pockets of tech and industrials. Now, those stocks outside the U.S. are actually quite cheap because those markets are cheaper. So buying some consumer stocks that have benefited from lower inflation, buying some industrials and some semiconductor stocks. A lot of the prices for similar businesses in the U.S. are outside of the maybe the price range that some value investors are comfortable with. So that's kind of helped. And also a big component is Japan. And Japan, has seen a lot of corporate reform, cross share holding unwinds. It's just shareholder friendly activities. And Japan is a very cheap market, it's been a cheap market for a while. It's been cheap for a reason, but that seems to be inflecting positively. So values worked particularly well in Japan this year.

C.V. | Outside of Japan. What other countries are you guys looking at in terms of attractive valuation?

J.J. | We still like a lot of Europe, the U.K. The U.K. is a really cheap market. I would generally say one of the things the market's looking at is the market saying, well, if inflation's going to slow and the Fed can start cutting interest rates, that to me means that, you know, if you look at the data, the dollar is very expensive. That means the dollar will weaken. And if the dollar weakens, that tends to be good for the commodity market. So we have a lot of opportunities just in metals and mining across the U.K. and also some stocks in Canada. I mean, when you look at the data, if you believe in the electrification trend, we're rapidly, rapidly short, short in the sense that we have too little supply of copper. So if indeed the central banks start to ease interest rates and economic growth eventually accelerates, I think we'll probably see a world with a lot higher copper prices and that should benefit some of our investments in the metals and mining space.

C.V. | Let's stick with that theme of commodities and energy. Why have oil prices dropped? Do you think that energy and commodities, I mean, you mentioned the attractiveness of copper and anything that has to do with the electrification of the world are still attractive from both a valuation and maybe even a quality perspective.

J.J. | Yes. Oil's I mean, my general perspective is in the last kind of 5 to 7 years, we've underinvested in commodities broadly as capital is flowing into tech and consumer and generally out of the commodity space. And you can look at those relationships over time. And when capital spending compresses or goes down, it usually means you're under-investing. And that's what you've seen both in metals and mining and oil. Now, the argument against oil is that we'll have weak demand, but we've actually seen pretty good demand this year across both the developed market and China, particularly as China is trying to reopen. Now, what's happened in the oil market is to me, there's some politics behind it. The U.S. is coming into an election cycle next year. And quite frankly, some of the things that we've seen is that Iran, which is a heavily sanctioned country, is producing well, it looks like about a million barrels per day, more oil today than they were a year ago. And that's sanctioned oil. But from all I can tell and what we're looking at, it looks like the U.S. government is turning a little bit of a blind eye to that right now with, I would say, the incentive that they want low oil prices, they want lower inflation, and they have an election coming. So that really means when you look at the data, the world is producing about as much oil as it can today, which means if you look at it, we have very little spare capacity. So if something does happen in the world, either the economy eventually accelerates and or there's some kind of supply shock, we literally have no cushion at all, at least from what's reported in the data. We think spare capacity is heavily overstated.

C.V. | Let's talk about financials, more specifically international banks. As I mentioned in the outset, the U.S. had a banking crisis early on in the year, but international banks are set up a little bit different. It's a very different system outside of the U.S. Can you compare and contrast the two and tell us where you see any opportunities there?

J.J. | Yeah, I think if you reflect on kind of what happened post the GFC, where generally banks got in trouble kind of everywhere, if you will, and Europe, that was delayed until 2011 or 2012 when you had kind of the euro banking crisis. I would say generally U.S. banks originally recapitalize their balance sheets the fastest, which put them in a position to grow loans, return capital to shareholder. But the stocks largely responded to that. The banks run in banking terms about as much capital as they need to from a regulatory standpoint, but they're not effectively heavily over capitalized. And then at the same time, in the U.S. market, you've had a little bit of a weird dynamic between how money market funds can lend back to the Fed at high interest rates relative to how some of the regional banks can price their own basically deposits. Obviously, as an American, if you're listening to this, you can get a much higher rate in a money market fund than you can in checking your savings account. What that has meant is money's flowed out of deposits into money market funds and that's created some huge imbalances. And those imbalances hit banks like Silicon Valley Bank, First Republic Bank particularly hard. They basically couldn't manage it. So we saw a market in that period of March of this year where the market started to worry about banks everywhere. And now outside of Credit Suisse, which to us looked like a problematic bank for a while, the European banks don't have that issue. So it's a much more consolidated market. There's fewer banks in general, so you don't have all the small regional banks. And what has generally been actually a problem for the European banks for the last ten years, which is the regulators have made them hold a ton of excess capital, 50-60% more capital than you see at an equivalent U.S. bank. And the regulators have also forced the banks to over collateralize any duration mismatches. This basically just left the banking system in Europe much safer. And that's a very different situation than where it was ten years ago. So for the first time in my career, I think European banks look healthier than U.S. banks. And then also, just as an extension, Japan may be coming out of an era of negative interest rates, which is going to be very beneficial for those banks. I would have said generally six, seven years ago, U.S. banks look better. That looks like the opposite today.

C.V. | How does that translate from a valuation perspective? How are the U.S. banks trading relative to the international banks?

J.J. | Generally speaking, if you look at the international portfolio today, our average bank is around 70-80% of book value and earning the same returns on equity on arguably an over capitalized balance sheet relative to U.S. banks at well over book value, 1.1, 1.2 times book value for several a return on equity. So U.S. banks 10, 11 times, 12 times earnings not necessarily expensive, but their peers in Europe on five or six times, which is pretty extreme when you look at it.

C.V. | Let's shift gears away from sectors and let's focus on capitalization. Your strategy has the ability to be very flexible and invest in an all cap opportunity set. Where are you finding opportunities right now within the portfolio, across the cap spectrum?

J.J. | Yeah. So we haven't been heavy on small caps since ten plus years ago, so we've been up to 30, 35% small caps if we're finding a ton of value there. We've been sub 5% lately. Generally, their portfolios valuation is the best we've seen since we watched the product in 2008. So all is equal. If we can do that at a higher cap means we're taking less liquidity risks. So we haven't really felt like we needed to go into small caps. Now what's basically happened over the last year and a half that as markets have rebounded off their lows in 2020, the international markets have seen the same trend that the U.S. markets have, which is mega-cap companies have generally outperformed mid-cap companies. So we are incrementally finding more opportunities in the mid cap space. So it's just generally on the margin, I would say we're kind of starting to add to some of those stocks in favor trimming some of our larger cap stuff.

C.V. | I want to spend a little bit of time talking about the valuation gap between the U.S. and the rest of the world. There's always been a little bit of a discount for investing outside of the U.S., but you know what closes that gap? What's happening there?

J.J. | Yeah, so that's the argument against international investing. The argument for it is that the equities are cheaper. The argument against it is that they're always cheaper. So I think the way to look at that is you basically have to look at the data and look at relative cheapness, right. And the quality of which you're effectively trading down. So in a very simple sense, when we run our quantitative data, we look at effectively three main factors, which is value, quality, fundamentals and momentum is the third factor, which I would kind of view as a reflection of earnings growth, if you will. And so when you've left the U.S. market, you generally got better valuations, but you traded down quality and oftentimes traded down momentum, which is just saying that, yeah, you're getting cheaper stocks, but they deserve to be cheaper. Ten years ago, I could have sat here and said, here's a valuation argument for going internationally, but there was a huge trade down in quality. So basically our quant model said ten plus years ago the S&P was, yeah, it was marginally more expensive than the rest of the world, but it was really high quality with really good momentum. That just meant it was going to be hard to beat and that was post GFC, everything was cheap. And honestly, 2010 2011, people hated the U.S. market, they hated the dollar, they like commodities and you wanted to do the exact opposite, and just step up and buy the S&P 500. Today, when you look at that relationship, the valuation discount for non-U.S. equities to U.S. equities, this is the largest it's been in 20 years. And also probably even more powerful, the quality of non-U.S. companies has closed the gap. So they're still slightly marginal, lower quality, according to our quant data, but at a much smaller degree than they have been historically. And in fact, International, the portfolio today, the quality or what we would define as our quantitative fundamental score of our companies is the best it's been since 2008. So I think that's just a reflection of capital flows, more capital is flowing into the U.S. market, flowing out of these markets, so management teams are just more focused on improving margins and returning capital to shareholders because that's the signal that the capital markets are sending them.

C.V. | Companies aren't cheap for no reason. Right? So outside of the U.S., is there are there more value traps? How do you avoid them? What part of the Boston Partners investment philosophy and process helps us mitigate investing in value traps?

J.J. | Yeah, so we defined our process is kind of the three circles investment process, which is where ultimately fundamental value investors, but we try to incorporate quality and momentum into portfolios. We are bottom up, so each security is purchased on an individual basis with the thesis as to why that business is a good business to invest in at the price that we're purchasing it. But in aggregate, when you want to basically put all of those positions together, you can see, if you will, the composite metrics or quality of the portfolio. And a big focus is just simply making sure that not only is the portfolio cheap, but it has quality underlying momentum and you can compare it with a relative indexes, right? Our clients have the choice of going and buying passive indexes. They can buy the MSCI EAFE Value Index. And EAFE Value Index is cheap, nine and a half times earnings, it's about a 7% free cash flow yield. If you look at the International Equity Fund that I manage, it's about nine and a half times earnings and a 7% free cash flow yield. So it has similar valuation metrics to the EAFE Value Index, but our companies on average have substantially higher returns on capital, they are also growing their earnings faster, which basically means we've created a portfolio of companies that are as equally cheap as the Index but are much higher quality. That's effectively an investable anomaly, if you will, against the Value Index. We think we've been able to replicate the valuation metrics of the Value Index, but again, with companies that don't deserve to be cheap other than those there may be value traps in the Index.

C.V. | Let's talk about the headlines that we're seeing out. There are policies here in the U.S., whether it's 2024 being an election year. I know you touch upon that already or the Fed. Is it going to be a soft landing or not? What are they going to do with rates? How might that impact your view, investing outside of the U.S.?

J.J. | Yeah. I mean, so from my perspective, one of the things that I look at and it's I apologize, it's a bit of minutia, but there's some really kind of weird things happening with the central banks balance sheet in the U.S. market that just we haven't seen historically and that are largely related to kind of the QE era, if you will. And that was really because the Fed created a mechanism called the reverse repo facility, which allows money market funds to lend back to the Fed, and that allows monetary policy to clear in a period where there was excess bank reserves. Those balances, basically, if you go back two years ago in 2020, early '21 were effectively zero. So there was very little being lent back to the Fed by money market funds. At the peak of interest rates last year, that had grown to $2.3 trillion. So $2.3 trillion of money had been lent back to the Fed by money market funds. That basically shrunk bank reserves, so when bank reserves were shrinking, the S&P 500 and FAANG stocks, or Magnificent Seven, went down. In October of last year, that started to kind of trend sideways and the reverse repo balances have been drawn down from $2.3 trillion to about $800 billion today. That's money that's come off the Fed's balance sheet back into bank reserves and it's added liquidity. So you've had this kind of Goldilocks period where as inflation expectations have come down, the Fed has signaled that they're done and the market's starting to discount that they'll actually cut. Money's flowing off of the Fed's balance sheet back into bank reserves and it's created a lot of liquidity. I think that's largely what's propelled a lot of these stocks higher. We could talk about A.I. and all that stuff and I there's a real trend there, but if you just look at the math, the stocks have responded by more than maybe the earnings would suggest that they should have. So when I look at that, effectively, it means that there's only about $800 billion left to go and because the Treasury, the U.S. Treasury is running such huge deficits, well over $2 trillion a year, and the Fed is still trying to unwind their balance sheet, it means those liquidity dynamics have about until March to be additive to the system and then they'll turn rapidly negative. That could create a lot of problems for the equity market in the U.S. and into an election year that could create quite a bit of volatility. Now, I think the Government won't want the equity market going down into an election, but they won't want rates going down. And if you look at the data as inflation's lower, that means also the comps get harder. So if there's any stickiness to inflation, it will start to show up next year. And if indeed we start to see oil kind of come back and it adds an inflation element to the market, the outcome in terms of what works next year for the equity markets could be substantially different than this year and maybe more like 2022.

C.V. | What about Treasuries issuance? You know, we've had some pretty weak auctions lately. How is that impacting the overall sentiment? And then how does that translate into how you think about positioning the portfolio internationally? Or said another way, if you're a U.S.-based investor, why would you want to invest internationally given what's going on here in the U.S.?

J.J. | One of the big benefits of international investing is you're basically taking non dollar exposure, right? So there's a return element to both the stocks locally and then there's a return element through the currency. And oftentimes the best periods for international investing have been in weak dollar periods. Now Treasury is running about a two plus trillion dollar deficit, but the Treasury to basically take advantage of all those reverse repo balances, it's been mostly issuing T-bills a really short duration Treasury debt. Typically they only issue I think around 15% of their debt is 12 months or less in T-bills. And they've been up close to about 60% this year. So as the arguably inflation in the economy slows, the market expects the Fed to start cutting, which I think they will have to do to basically support all this deficit spending. But that may mean that interest rates at the short end of the curve comes down, the dollar weakens, but it may mean that long, longer term interest rates stay a little bit higher than people expect. And that could cause problems for U.S. equities. Create a scenario where you have a weak dollar and that tends to be pretty supportive for international equities in general.

C.V. | So the impact of the dollar directly impacts the attractiveness of international equities.

J.J. | Yes. So in a simple sense, if international equities are up 10% locally and the dollar's down 10% against the backs of those currencies, your return as a dollar-based investor is 20%. That's the ten plus the ten. We've been in a dollar bull market for the last ten plus years, and by most metrics the dollar is quite expensive today. It's about as equally as expensive today as it was cheap post-GFC in 2010, 2011, which is not surprising when people hated investing in dollars.

C.V. | Mm hmm. And what's the impact of the actions of the European Central Bank and the Bank of England on what's happening locally in those specific countries or regions?

J.J. | If you look at the currency markets, they tend to basically price themselves on interest rate differentials. So the U.S. economy has been the strongest economy in the world, which has also meant that for the Fed to slow the U.S. economy, they've had to raise interest rates a lot higher than the rest of the world. That's why the dollar's stronger today. So if the U.S. economy really slows next year, particularly as the Treasury has big deficit issuance issues, which could be the case, it may mean the Fed's forced to lower rates here more than the rest of the world. And that's where you'd get the dollar weakness. It's hard to predict because you're basically saying the Fed will have to cut rates eventually more than the BOE or the ECB.

But certainly the ECB is at 4% and the Fed's at five and a half. So there's just effectively, I would say interest rates are more punitive in the U.S. market than they are abroad that's caused the dollar to be more expensive today. But that could obviously reverse.

C.V. | And let's say we're going back to this normalized well, obviously, we're not going back to zero, but more of a normalized interest rate environment. Is that a good environment for value equities?

J.J. | Yeah. The misnomer is that if interest rates go down, it's bad for value equities. But what we're talking about in terms of interest rates going down was we're talking about short term interest rates, right. The central bank policy rate, effectively. The policy rate they've said is restrictive. I think the market sees normal policy rates as 2 to 2 and a half percent. The market cues off the long end of the curve, so if they lower interest rates at the short end, but you get normal kind of term structure, that could mean that the long term interest rates are bouncing between four and 5% and that's potentially very good for value equities in the sense that you're allowing the economy basically to expand. But long term interest rates aren't coming down as much as people expect. What happened in 2018, 2019 was that the market was so convinced that inflation was just totally dead that long term interest rates collapsed. And that's what really propelled kind of these stratospheric valuations for effectively long duration equities.

C.V. | That leads me into my last question, and we'll wrap things up here. What's your outlook for 2024? Given all that we discussed?

J.J. | Ultimately, we focus on trying to kind of create the right portfolio of companies that have attractive characteristics. My general sense is a lot of the consumer and industrial stuff that's done well this year will actually struggle more next year. I personally think the U.S. market's going to peak in the first quarter and then really struggle for the rest of the year. And I think some of the commodity markets like copper and energy, I personally think oil is actually going to be under pressure through March, but then I think it's going to move a lot higher and a lot of the commodity markets to do better. And I think some of the financials that the market perceives as potentially having peak earnings through peak interest rates, the interest rate market, even if the short term rates come down, as we talked about, if long term interest rates stay a little higher. That can actually be good for a lot of the financials like insurance companies. I think we're going through a volatile period. I mean, my general take is that some of the liquidity dynamics that have been very additive to the market for the last ten plus years are going to be more difficult. But I think it's going to be a lot of up and down. So '22 was down. This year is up, next year will be down. I don't think it's anything super dramatic, but I think it's just going to be kind of frustrating for investors. So that should create opportunities for active management. But I certainly think we'll see quite a bit of volatility next year.

C.V. | Thanks, Josh. Really appreciate your insights.

J.J. | Thank you, Chris. Thanks for having me on.

C.V. | That was Josh Jones, Boston Partners portfolio manager, joining us from London. Stay tuned for more world views and market perspectives on future episodes of the show. Meanwhile, look for deeper investment related content from Boston Partners on our Entry Points video series, and more can be found on our website at Boston-Partners. com. Also give us a follow on our LinkedIn page to stay on top of the latest information and analysis from our team. I'm Chris Villalba. Happy holidays. Will see you next time with more Boston Partners Insights.

Christopher Villalba
Investor Relations

Mr. Villalba is a member of the Investor Relations team at Boston Partners and joined the firm in July 2010. In this capacity, his responsibilities include sales and relationship management of Boston Partners products within financial intermediary channels. Prior to joining the firm, Mr. Villalba was a regional private banker with Wells Fargo Bank, N.A. Before that, Mr. Villalba held the role of investment associate at Morgan Stanley in the firm's Global Wealth Management division. He holds a B.B.A. degree in finance from Pace University and FINRA licenses series 7, 66, and 3. Mr. Villalba began his career in the industry in 2007.

Joshua Jones, CFA
Portfolio Manager

Mr. Jones is a portfolio manager on the Boston Partners Global Equity, Global Long/Short Equity and International Equity strategies, with primary responsibility for managing the firm's International Equity as well as Global Long/Short offerings. Prior to this role, he was a research analyst specializing in the energy, metals and mining sectors of the equity market and was a global generalist. He joined the firm in January 2006 from Cambridge Associates where he was a consulting associate specializing in hedge fund clients. Mr. Jones holds a B.A. degree in economics from Bowdoin College. He holds the Chartered Financial Analyst® designation. Mr. Jones began his career in the investment industry in 2004.

Terms and Definitions

GFC: The 2007–2008 financial crisis, or Global Financial Crisis (GFC), was the most severe worldwide economic crisis since the Great Depression.

QE: Quantitative easing (QE) is a monetary policy action where a central bank purchases predetermined amounts of government bonds or other financial assets in order to stimulate economic activity.

BOE: Bank of England.

ECB: The European Central Bank (ECB) manages the euro and frames and implements EU economic & monetary policy. Its main aim is to keep prices stable, thereby supporting economic growth and job creation.

S&P 500® Index: The S&P 500® Index is a registered trademark of the McGraw-Hill Companies, Inc. and is an unmanaged Index of the common stocks of 500 widely held U.S. companies.

Magnificent Seven stocks: Apple (AAPL), Microsoft (MSFT), Google parent Alphabet (GOOGL), Amazon.com (AMZN), Nvidia (NVDA), Meta Platforms (META) and Tesla (TSLA).

Disclosures

This Boston Partners Global Investors, Inc. ("Boston Partners") is an Investment Adviser registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. Registration does not imply a certain level of skill or training. Boston Partners is an indirect, wholly owned subsidiary of ORIX Corporation of Japan ("ORIX"). Boston Partners is comprised of two divisions, Boston Partners and Weiss, Peck & Greer Partners ("WPG").

Securities cited are to illustrate our investment process and analysis only and should not be considered a solicitation to buy or an offer to sell a security. The specific securities listed do not represent all of the securities purchased, sold, or recommended for advisory clients. You should not assume that investments in the securities identified and discussed were or will be profitable.

This podcast is not an offering of securities nor is it intended to provide investment advice. It is intended for information purposes only.

The views expressed reflect those of Boston Partners as of 12/19/2023. Any such views are subject to change at any time based on market and other conditions and Boston Partners disclaims any responsibility to update such views. Discussions of market returns and trends are not intended to be a forecast of future events or returns.

Boston Partners | One Beacon Street, Boston, MA 02108 tel: 617-832-8200

www.boston-partners.com