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Tour de World: Global Equity Investing Now

A Commonfund Forum Spotlight

From left to right: Mark Bennett, Raj Venkatesan, James Syme and Miriam Schmitter

Better Valuations. Innovation hotspots. Opportunities to add value. Geopolitical tensions. Debt burdens. Trade imbalances. Equity investing outside the U.S. holds its attractions—and risks. A report from the frontlines.

Commonfund Forum 2024 convened a Forum Spotlight panel of hands-on investors to take a close—and timely—look at equity investing beyond the U.S. in an environment that holds both promise and peril. The panelists were: Miriam Schmitter, PhD, Managing Director, CF Private Equity; James Syme, Senior Fund Manager, JO Hambro Capital Management Group (JOHCM); and Raj Venkatesan, Founder and Chief Investment Officer, Trinity Alps Capital Partners. Mark Bennett, Managing Director, Commonfund OCIO, served as moderator.

The panelists' affiliations are: JOHCM, a London-based equity manager with nine offices around the world and extensive experience in emerging (and developed) markets; Trinity Alps, located in San Francisco, a boutique investment management firm with a focus on international developed markets; and CF Private Equity, a pioneering investor in private equity and venture capital both in developed and emerging markets around the world.

Mark Bennett: Returns from non-U.S. equities have lagged those of the U.S. for quite some time, and we want to discuss that. But we also want to look more closely at opportunities and risks around the world in both public and private equities, including stops at some of the world's major markets, developed and emerging. Let's begin with those valuations and relative performance in terms of the U.S. versus the rest of the world.

> *Small and middle market private equity managers can take advantage of Europe's fragmented market*
>
> *– Miriam Schmitter, CF Private Equity*

VALUATIONS AND PERFORMANCE

Bennett: The S&P 500 has compounded at a rate of about 12 percent a year over the past decade. Non-U.S. developed market equities have returned about 4 percent annually over the same period and emerging markets just 2 percent. Why?

Miriam Schmitter: Private markets returns have been quite a bit different than public market equities. In the U.S., top-quartile buyout and growth managers would have delivered internal rates of return (IRRs) averaging 26 percent annually over that period. For top-quartile managers those same strategies in non-U.S. developed markets—which would be about 80 percent Europe plus Japan and Australia—the IRR is neck-and-neck at 24 percent annually. For median managers in the U.S. the IRR averaged 17 percent, ex-U.S. it was 16.2 percent. In emerging markets, the numbers would be about 10 percentage points below the U.S. and Europe.

Returns have been strong in Europe because of the niches of growth. As an example, in our European portfolio, as in our U.S. portfolio, buyouts of smaller, niche software companies have been rewarding and there are hundreds of these companies, making for a strong opportunity set. That's a lot of the reason the returns in the U.S. and ex-U.S. private markets have been so similar.

Raj Venkatesan: As investors, we sometimes think about growth as economic growth when in reality making money on stocks and thinking about economic growth are two different things. Three factors drive real economic growth over time: the working age population, productivity and the long- and short-term debt cycle. When I'm investing, I also look at the incentive structure for equity investors. Right now, these factors are all positive for the U.S. You see it in the incentive structure for equity investors and entrepreneurs, whereas it's much more difficult to find when we search country by country overseas. Another reason it's so appealing to invest in the U.S. is its continental economy … in other words, tremendous scope and scale not only in tech but across a great many sectors. That's an advantage that can be hard to find in other countries.

James Syme: From an emerging markets perspective currency is a major component of the underperformance. The strong U.S. dollar impacts emerging economies in a way that doesn't apply to developed markets because emerging countries are generally deficient in terms of savings and investments and are very dependent on external capital. A strong dollar represents money going into the U.S. while a weak dollar represents money flowing out of the U.S. dollar into other currencies. When that happens, it has a hugely stimulative effect on emerging economies and emerging companies. Over the last 10 years the U.S. dollar has been strong for all sorts of reasons and that leads to weakness in emerging economies, emerging company profits and, hence, emerging markets. I can't make the case right now that the U.S. dollar will weaken anytime soon. But when it comes, the impact on emerging economies and emerging markets will far outweigh what you see in developed markets.

CHINA

Bennett: For 30 years China has been a central investment thesis. Now the question is whether China is investable.

Syme: China has no democracy anywhere within its governance. Human and property rights are at the whim of Communist party leaders and that was fine until it wasn't. The last few years have seen some extremely unfriendly market policies imposed and they have affected domestic confidence and global investors' views. Bear in mind, much of the outperformance was due to levering up the economy, which resulted in a huge increase in debt to GDP. Policy makers finally stopped and growth has reacted accordingly.

Schmitter: For some 20 years China had strong returns driven by a very deep pool of talented and extremely hardworking entrepreneurs who have written remarkable success stories. Historically, 15 percent of our private equity program was in emerging markets and about 60 percent of that was China. We're in a very different situation now, the most important element being geopolitical. At least temporarily, we have reduced our exposure to emerging markets and specifically to China.

Bennett: Raj, given two choices, opportunity or tail risk, where would you fall on the China question?

Venkatesan: Tail risk for sure. It's not that you can't have a trade, but on a long-term basis I agree with what's been said. Two points: We can debate whether the debt-to-GDP ratio is 250 percent, 300 percent or whatever. It's not clear. But it's a big number and it makes U.S. debt seem pretty low. Second, the bulk of that debt is in renminbi and we don't know how much in aggregate will be in U.S. dollars. I think it could play out to be 20 years of Japanese-type growth and that's a difficult environment in which to make money.

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> *A generational shift in Japan has managers running businesses with a focus on return on invested capital*
>
> *– Raj Venkatensan, Trinity Alps Capital Partners*

JAPAN

Bennett: Turning to a story that's more optimistic, a lot has been going on in Japan. Raj, what's happened to turn it around?

Venkatesan: You still can't make an investment case based on growth, but you are seeing corporate debt coming down a lot. Productivity has improved for a number of reasons. The working age population is still a problem, but generationally the managers who became CEOs post-war were very operationally focused but not so much financially focused. That's because they had such high returns on capital. Then the bubble burst and companies just wanted to survive. As a result, decisions were not great for long-term equity holders. Now, you have a generational shift where managers in their 40s and 50s are running businesses with much more of a focus on return on invested capital.

Schmitter: We have always liked Japan, but for a long time it was generally overlooked. There's a limited manager set but the quality is high and there is not too much capital pushing into the market. As well, Japan has historically been a value play where you can pick up companies for four to six times EBITDA ... perhaps a bit higher now, but below anywhere else. Speaking to generational transitions, there are many attractive succession or carve-out situations in Japan. Managers are also trying to diversify away from China, meaning that capital has been going to Japan and India.

INDIA

Bennett: India has a reputation of emerging as the next big thing every five or six years but failing to deliver. To Miriam's point, though, lately it has been receiving more capital. James, what are your thoughts about India?

Syme: India has benefited from some deep structural reforms, particularly in the implementation of digital technologies and in the intersection of society, government and business and these factors have opened pathways for growth. The vulnerabilities that India has faced in the past, its current account balance and inflation, now look benign. The challenge with investing there is that valuations are very high. If you pay 70X for a consumer company in India you're relying on a very long pathway of growth to get to a sensible valuation. We're talking seven to nine years. The potential is there in terms of unfulfilled growth and the addressable market. But it's unlikely that India can grow at its current pace without hitting some of those historic vulnerabilities. We had been overweight India but currently we're back to neutral.

Schmitter: India has disappointed somewhat, and a large reason is that the public markets there accommodate fairly small companies. So, the Indian public market prices its companies quite high and private equity managers either can't close a deal or the price is just too high. There have been some niches, like healthcare, that have done reasonably well. On the venture side we have seen more success. Obviously, there's a lot of innovation coming out of India and some incredible talent there.

EUROPE

Bennett: Miriam, Europe has been a destination for capital for a great many years. What does the opportunity set there look like from a private equity perspective?

Schmitter: Europe remains in an environment of low GDP growth. That said, there are lots of companies growing at a much faster pace than the very large, mature companies. In contrast to the U.S., Europe is very fragmented. But if you're a private equity investor in the small and middle market space you can take advantage of that fragmentation. Legacy management teams are often not able to scale across borders, banking practices vary, and there are language and cultural barriers. We have been working with local managers to uncover off-the-beaten-path opportunities. As a broader theme, software in general and software-as-a-service, which lags the U.S., is an opportunity to add value. There are always special situations and carve-outs in particular are having a moment as larger companies want to sell some of their orphaned assets.

> *"A weaker U.S. dollar will have a hugely stimulative effect on emerging economies*
>
> *– James Syme, JO Hambro Capital Management Group*

ELECTIONS AND TAIWAN

Bennett: This is a calendar year crowded with elections—including the U.S. and U.K. James, what do you see for emerging market elections where there's generally lower awareness in the U.S.?

Syme: I think a lot of them will play out as expected. There's a particular risk around South Africa, which appears to be attempting to throw its weight in with Russia and China. But for a country that enjoys a preferred trading relationship with the U.S. that could be a big mistake. There's the Mexican presidential election coming up. We have seen some transitions among popular parties in Latin America where they become more difficult under their second leader. It's possible that Claudia Scheinbaum replaces Andrés Manuel Lopez Obrador, referred to as AMLO, and that Mexico becomes more politically difficult over the next few years.

Bennett: Speaking of elections, Taiwan had elections earlier this year, but it doesn't seem to have ramped up tensions with China.

Syme: What I would say in one sentence about Taiwan is that since 1953 North Korea has been poised to attack South Korea and if, in 1953, you had decided not to invest in South Korea for that reason you would have missed what I think may be the single best economic story in the world since that time. China may attack Taiwan. It may never attack Taiwan. To assume that it's inevitable and invest accordingly is, I think, a mistake. I suspect the next geopolitical shock, one that we didn't see coming, won't be in the South China Sea. It will more likely be in the Middle East or North Africa.

Venkatesan: We've talked to a number of generals, retired military, foreign policy and CIA people and those discussions have made it pretty clear that invading Taiwan—having an actual amphibious assault—is extremely difficult. We have continuously heard that if China were going to do that it would need about four years to prepare, and the experts haven't seen anything that suggests that level of training and preparation. It doesn't mean it won't happen. But China's military, large as it is, doesn't seem on the verge of an efficient invasion of Taiwan.

Bennett: Many thanks to our panelists for their insights into global investing—what's been happening and what we may want to look out for going forward.

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