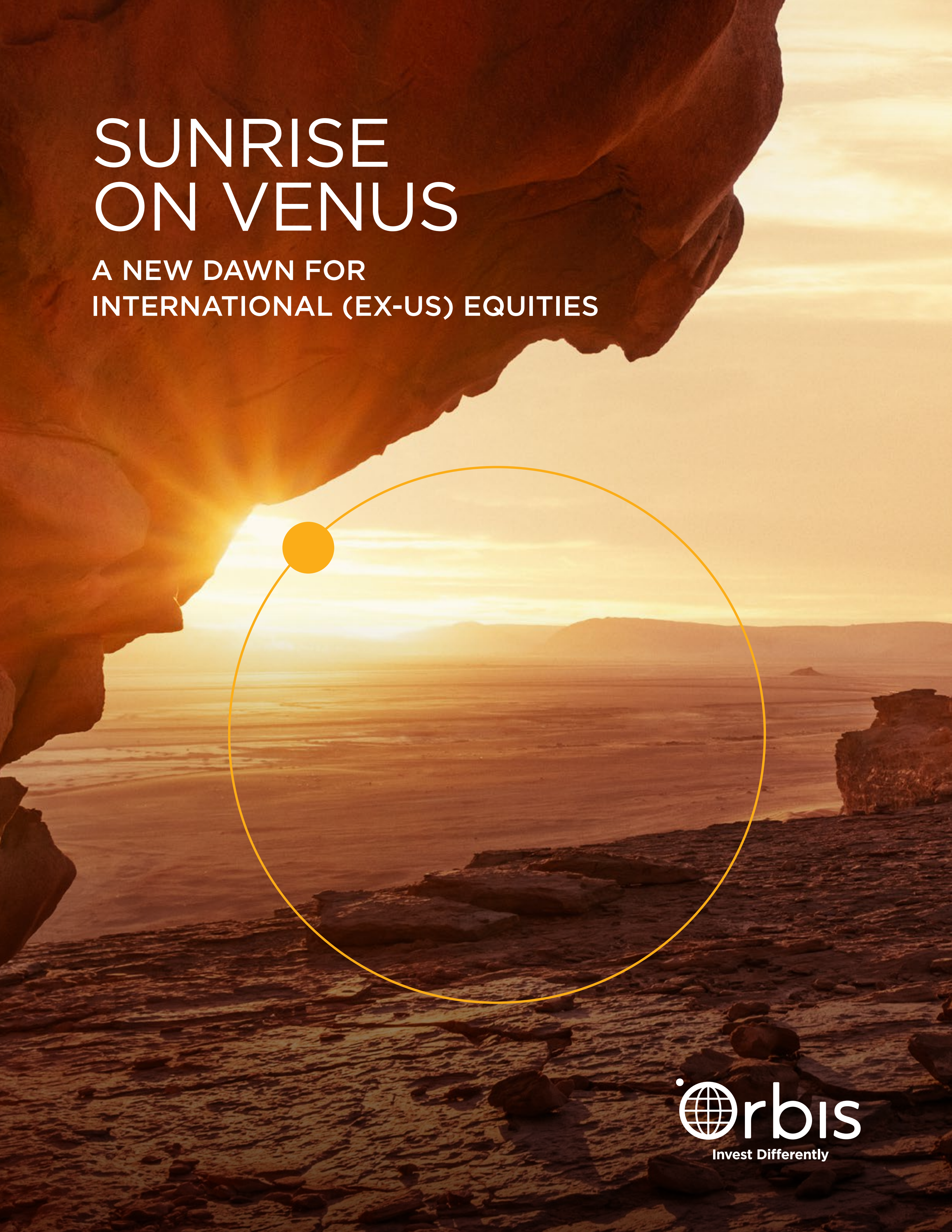
SUNRISE ON VENUS

A NEW DAWN FOR INTERNATIONAL (EX-US) EQUITIES



Orbis

Invest Differently

INTRODUCTION

Venus goes 117 days—or nearly four months—between sunrise and sunset. The US stock market enjoyed a much longer day in the sun in the years following the Global Financial Crisis (GFC), while investors in international (ex-US) markets endured a prolonged period of darkness.

As a result, many of today's investors have never seen a sustained period of ex-US outperformance. But when the days and nights never seem to end, it can be easy to get disoriented and confuse normal market cycles with permanent, structural changes.

Amid the chaotic markets of early 2025, the sun finally began to rise in earnest for ex-US equities. While much uncertainty remains, we believe it is a compelling time to diversify outside the US, and active managers have an exciting opportunity to add value through stock selection.

In this paper, we take a closer look at some of the reasons why the next 15 years may look very different.

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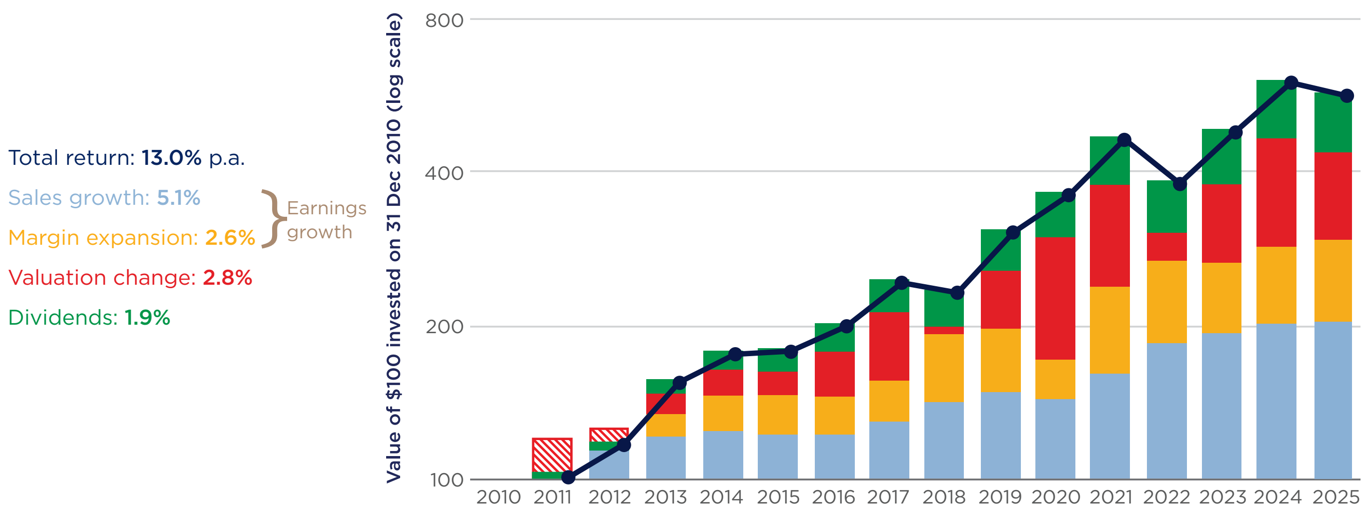
A LONG DAY IN THE SUN

The past 15 years were a glorious time to own US equities. In the wake of the GFC, the Federal Reserve and other global central banks responded aggressively with interest rate cuts and extraordinary monetary stimulus. A long bull market followed, interrupted briefly by an indiscriminate "COVID Crash" in the early part of 2020, which only set the stage for even more dramatic policies that inflated an epic speculative bubble in 2021. After another brief intermission in 2022, the US continued to rally, most recently fuelled by enthusiasm for all things artificial intelligence (AI) related.

The one constant throughout much of this period has been a backdrop of unusually low and steadily declining bond yields. Like a gravitational force, low and falling yields—nearly "free money"—helped drive higher equity valuations while also distorting valuations among groups of stocks. The biggest wave of mispricings—what we have termed "The Great Misallocation"—was largely characterized by a massive disconnect between short- and long-duration assets, or more simply, "value" versus "growth" stocks. Just like the late 1990s, investors wanted nothing to do with boring old-economy businesses like banks or oil companies and could not get enough exposure to new-economy companies like those in software or AI.

As the home of Silicon Valley and the world's largest concentration of technology companies, the US market in particular was a prime beneficiary of investor enthusiasm and capital flows, creating a wide performance gap between the US and the rest of the world. Over the last 15 years, US stocks delivered a total return of 13% per annum (p.a.) versus roughly 5% p.a. for ex-US equities. Breaking down the US market's return into components, we estimate that roughly 8% was driven by earnings growth, 3% by multiple expansion, and 2% by dividends. Digging deeper, we can split the earnings growth component into a combination of sales growth (roughly 5% p.a.) and margin expansion (roughly 3% p.a.) No matter how you slice it, this has been a truly impressive performance (Figure 1).

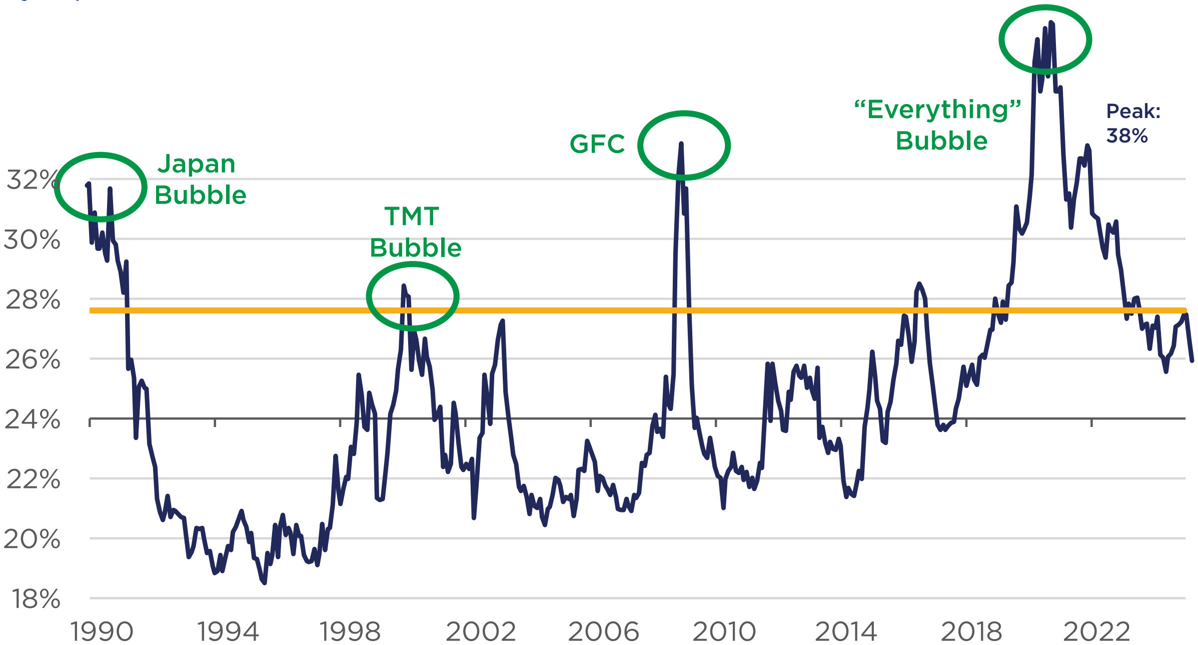
FIGURE 1: S&P RETURNS—SALES GROWING, MARGINS EXPANDING, P/E'S RISING, AND DIVIDENDS



30 Apr 2025 | Source: Orbis analysis, Bloomberg. 2025 is through 30 Apr. Chart shows the contribution from each driver to the S&P 500's total return for an investment made on 31 Dec 2010. Contributions are summed geometrically and may not sum arithmetically. Dashed red areas indicate years with a negative contribution from valuation change.

FIGURE 2: MARKETS ARE NOT GETTING MORE EFFICIENT OVER TIME

Spread of expected return between top and bottom half of shares in the FTSE World Index ordered by expected return



31 Mar 2025 | Source: LSEG Worldscope Fundamentals, Orbis. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning. Spread is the dispersion of expected returns in the market as a whole. Expected returns are estimated using an internal proprietary model. TMT = Technology, Media and Telecoms. GFC = Global Financial Crisis.

The problem today is that many investors seem to be assuming that they can pencil in 13% annual returns indefinitely. It brings to mind a saying by Seth Klarman: *"At the root of all financial bubbles is a good idea carried to excess."* While the US may not be a bubble—at least not yet—we would argue that investors have clearly carried a good thing to excess. In 2010, the US was just 43% of the MSCI ACWI Index; today, it is closer to 65%. Back then, the S&P 500 traded at 15 times earnings; today, it trades at 23 times earnings.

History shows that good ideas taken to excess usually don't end well. Examples include the peak of the Japan bubble in the late 1980s, the peak of the dot-com bubble in the late 1990s, the peak of the emerging markets bubble in 2007, and the peak of the "everything" bubble in 2021 (Figure 2). All were good ideas driven by very real fundamentals—up to a point—but in all cases, investors got carried away with the prices they were willing to pay to participate.

In the case of the US market today, we fully agree that it deserves a premium valuation due to its superior fundamentals. But we do not believe the US is entitled to an *ever-expanding* premium. The best investments are made when the fundamentals are under-appreciated, not when everyone is in agreement. If anything, we would argue that the superior fundamentals in the US are over-appreciated at today's prices.

This problem is most acute for passive strategies. By holding shares in proportion to their market capitalization, "passive" strategies are actually more like active momentum strategies in disguise. They work beautifully for as long as the upward trend continues, as long as the winners keep getting bigger and making greater contributions to index returns, while losers keep getting smaller and detracting less from passive returns. A passive investor blindly following a global benchmark today is therefore effectively betting that the sun will never set on US mega caps.

THE RISK OF SUNSET

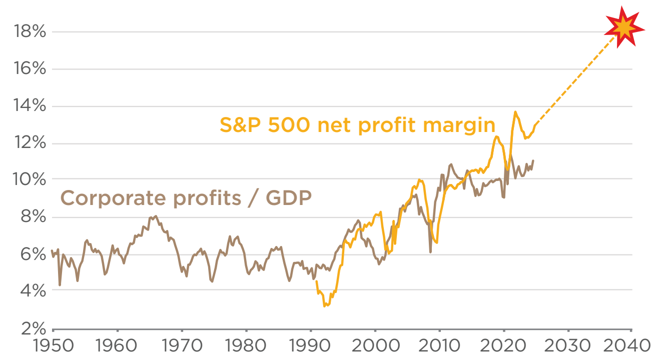
Looking at the US market today, investors need to decide what they believe the future holds. Can the US market sustain its post-GFC earnings growth trajectory over the next 15 years? And even if superior growth persists, what price will investors be willing to pay for it? What will returns look like if there is no longer a tailwind from lower rates? What will it take for the S&P 500 to deliver 13% annual returns for the *next* 15 years?

Here's one way to think about it. First, let's assume that the contribution from revenue growth (5%) and from dividends (2%) is repeatable. That means that the key drivers of future returns will be changes in margins and valuations. Over the past 15 years, margin expansion boosted US equity returns by about 2.6% p.a. If we assume the same rate of improvement over the next 15 years, net profit margins would need to be 19% in 2040—the highest ever in US market history (Figure 3).

And if we expect valuation multiples to expand for another 15 years in the same way that they did over the past 15, we'd be looking at a multiple of 34 times earnings for the S&P 500—well above today's already above-average multiple of 23 (Figure 4).

Stranger things have happened, but these assumptions leave very little room for error. If we assume that margins and valuations simply fall to their 20-year average levels, it would suggest a return of just 4% for the S&P 500 from today's levels.

FIGURE 3: TO GET 2.6% P.A. FROM MARGINS EXPANDING *AGAIN*, MARGINS MUST REACH 19%!



31 Mar 2025 | Source: Bloomberg, LSEG, US Bureau of Economic Analysis. Using trailing 12-month fundamentals. Corporate profit share of GDP is after tax, reflecting inventory valuation and capital consumption adjustments, and is updated to reflect the latest available data as at Dec 2024. Future value is the profit margin necessary at the end of the 15-year period for margin expansion to contribute as much to returns as it did over the 2010-2025 period. Future value is illustrative only.

FIGURE 4: VALUATIONS ARE CYCLICAL, AND ARE STARTING NEAR RECORD HIGHS

31 Mar 2025 | Source: Bloomberg, LSEG, Robert Shiller. Using trailing 12-month fundamentals. Future value is the price-earnings ratio necessary at the end of the 15-year period for valuation change to contribute as much to returns as it did over the 2010-2025 period. Future value is illustrative only.

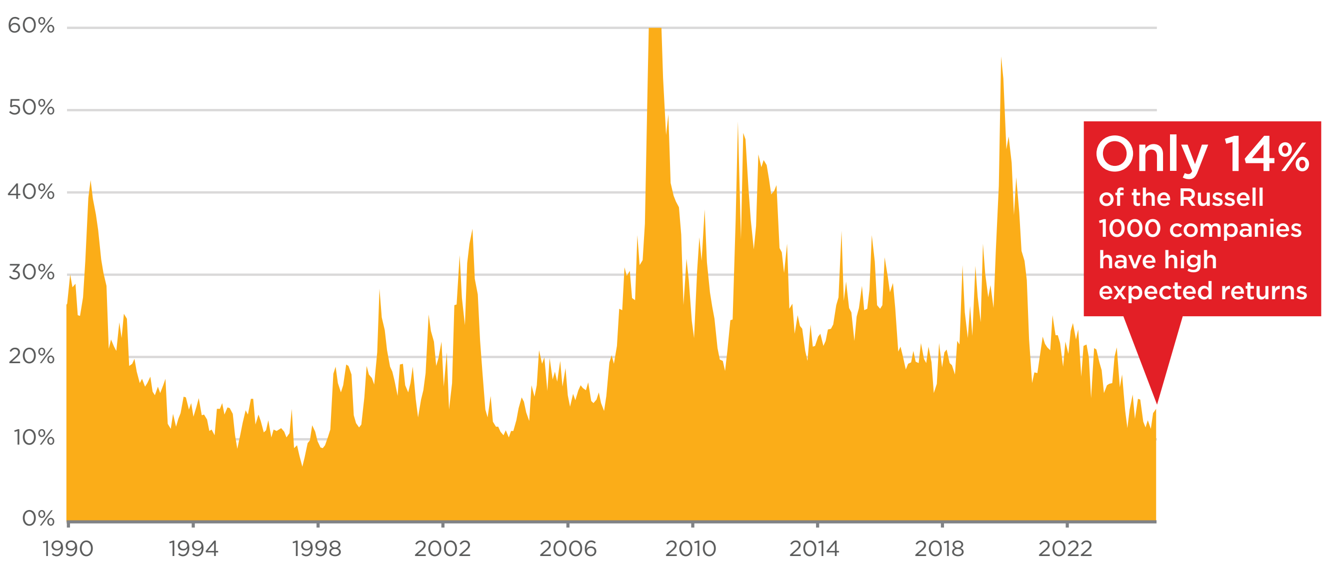
One thing we can say for certain is that the broader US market looks increasingly unattractive from a valuation perspective. As an illustration, the Orbis Quant Team uses decades of historical data to build models that estimate future returns based entirely on growth, profitability, and valuation metrics. Importantly, this approach gives companies credit for superior fundamentals. For example, a technology company with a strong history of growth and a high return on capital will command a higher valuation than, say, a poorly run bank trading below book value.

In Figure 5, we are looking at the Russell 1000 Index—the largest companies in the US by market cap. If we assume they are all equally weighted, what percentage of the 1,000 constituents look "attractive" based on our valuation models? To keep things simple, we assume a 15% p.a. forward return over 3-5 years, or 5% alpha potential above a 10% cost of capital assumption. Today, only about 14% of the index—140 US companies—would meet that criteria. This is below average historically and well below previous periods that were great buying opportunities for US equities such as the early 1990s, the GFC, and the "COVID Crash" of 2020.

For passive investors, this is a very risky starting point. The biggest winners are already well-loved, the pool of attractive new opportunities is shrinking, and the continued outperformance of the US depends on increasingly punchy assumptions. In our view, betting that the US will continue to outperform over the long term is a poor risk-reward proposition at current valuations.

FIGURE 5: A BELOW AVERAGE % OF US STOCKS LOOK ATTRACTIVE

% of stocks in the Russell 1000 with high quantitative expected returns



31 Mar 2025 | Source: LSEG Worldscope Fundamentals, Orbis. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning. Expected returns are estimated using an internal proprietary model. Shares with high expected returns are those where the model expects a 4-year annualised return of 15% p.a. or higher.

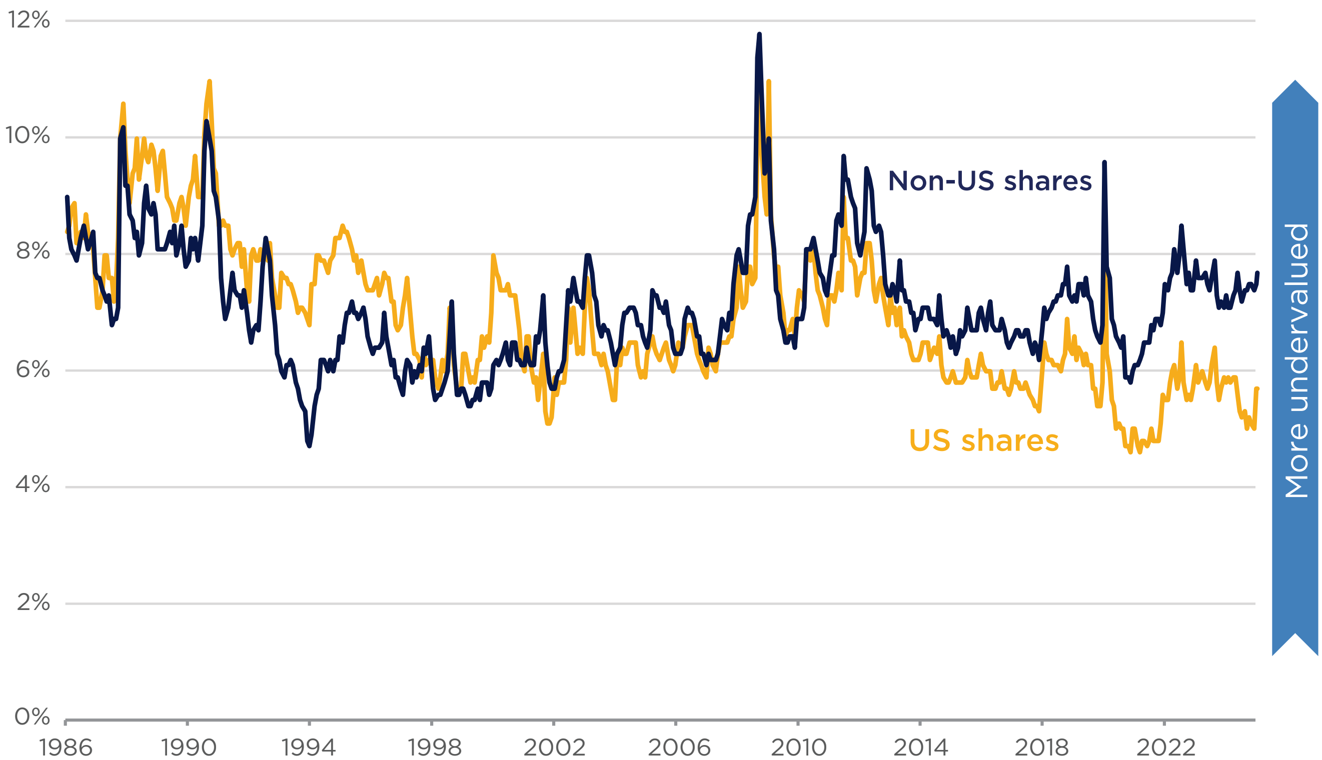
OPPORTUNITIES ON THE DARK SIDE OF VENUS

The good news is that there is an alternative—and a very compelling one at that. Whenever investors become obsessed with a particular asset class or investment theme—Japanese equities in the 1980s, tech stocks in the 1990s, emerging markets in the 2000s, or US mega caps today—it tends to create exciting opportunities in other areas that have been left behind.

Today, there is no better example than ex-US equities in that regard. As shown in Figure 6, the valuation gap between the US and the rest of the world is as wide as it has ever been.

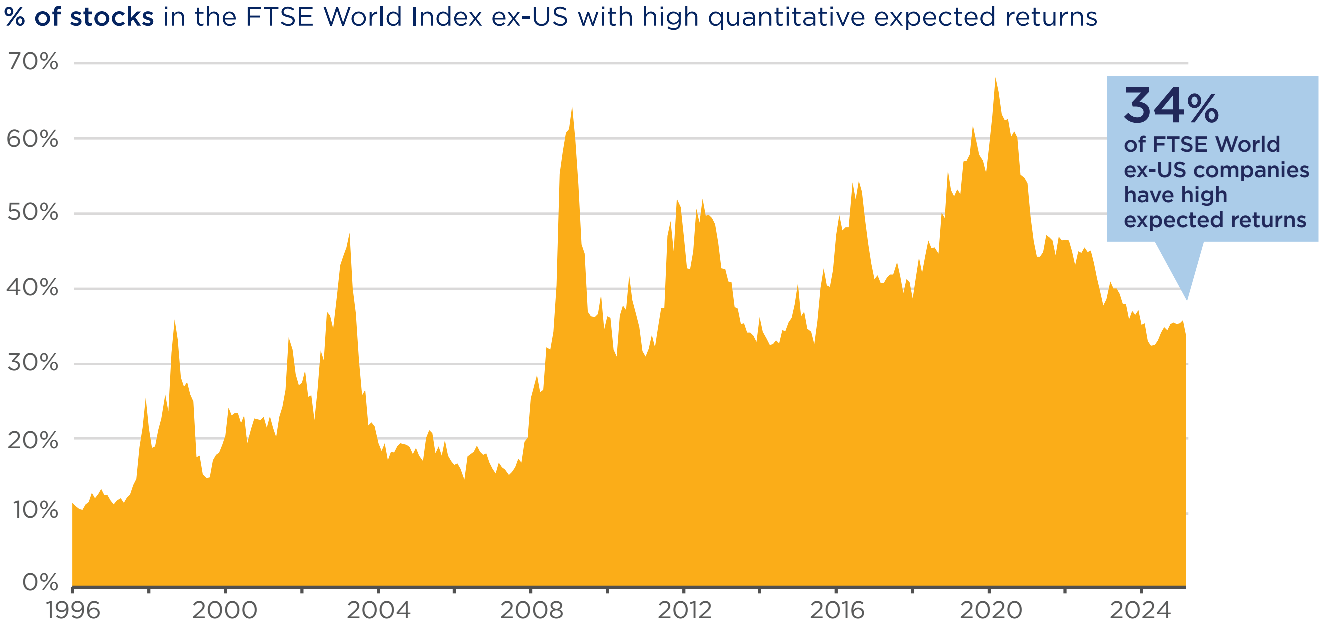
FIGURE 6: RELATIVE TO THE US, EX-US SHARES LOOK AS ATTRACTIVE AS EVER

Median forward earnings* yield of US vs ex-US shares in the FTSE World Index



31 Mar 2025 | Source: LSEG Datastream, LSEG I/B/E/S Estimates, FTSE, Orbis. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning. *IBES FY2 (next financial year).

FIGURE 7: AN ABOVE AVERAGE % OF EX-US STOCKS LOOK ATTRACTIVE



31 Mar 2025 | Source: LSEG Worldscope Fundamentals, FTSE, Orbis. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning. Expected returns are estimated using an internal proprietary model. Shares with high expected returns are those where the model expects a 4-year annualised return of 15% p.a. or higher.

For active managers, the opportunity is arguably even more exciting. Figure 7 shows a similar analysis to Figure 5, this time with the FTSE World Index ex-US instead of the Russell 1000. In this case, 34% of the stocks in the index look attractive. And the index has more constituents, so there are a lot more potential opportunities—around 670 stocks to choose from versus just 140 in the US.

“FOR **ACTIVE MANAGERS**, THE EX-US OPPORTUNITY IS ARGUABLY EVEN MORE EXCITING.”

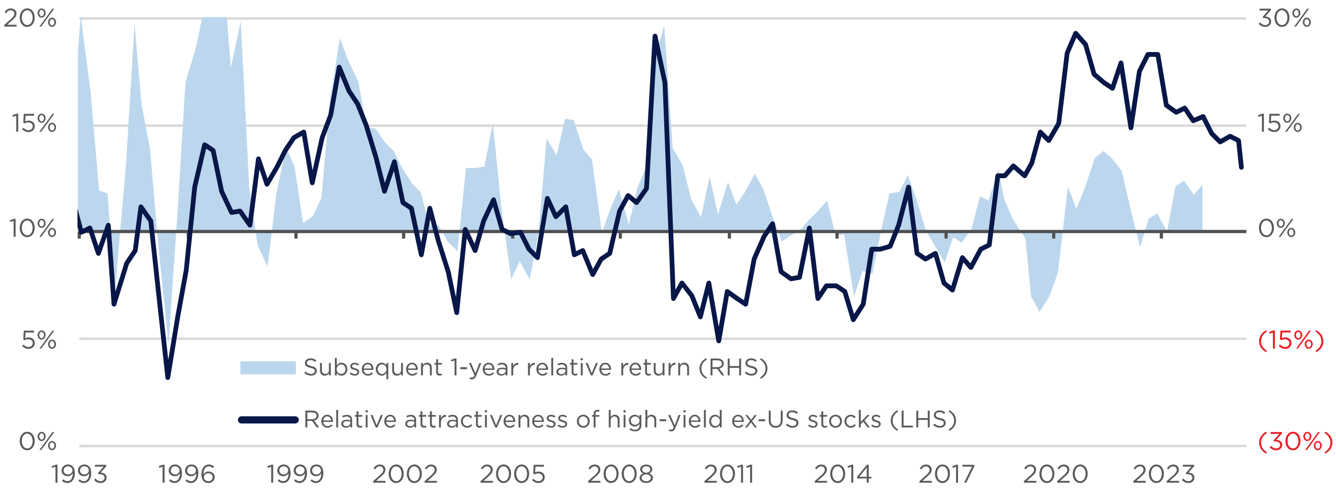
That said, not all potential opportunities are created equal. This makes a strong case for active management, where skilled managers can navigate regional and sector complexity to uncover the most compelling opportunities.

Within this group, one of the most striking examples we have seen is the relative valuation of high-yield, ex-US stocks. In normal market environments, investors ought to be able to find opportunities across the yield spectrum—from businesses that reinvest close to 100% of their cash flow in an effort to grow, to those that have lower growth opportunities and thus return more profit to shareholders. In the current environment, however, the relative attractiveness of the latter group of stocks is historically wide.

To put this in historical perspective, ex-US equities have returned just over 6% p.a. since 1990. That figure includes both price appreciation and dividends. In today's environment, however, it is not unusual to find ex-US shares that offer sustainable, real yields in the 5-7% range from *dividends alone*. If we make even modest assumptions about sales growth, margin improvements, and valuation multiple expansion, it is easy to come up with prospective total returns in the low double-digit range—something we cannot say about the US market today (Figure 8).

FIGURE 8: HIGH YIELD EX-US STOCKS LOOK CHEAP

Relative attractiveness of stocks in the high-yield half of the FTSE World Index ex-US, and their forward 1-year relative return vs the low-yield half of the Index

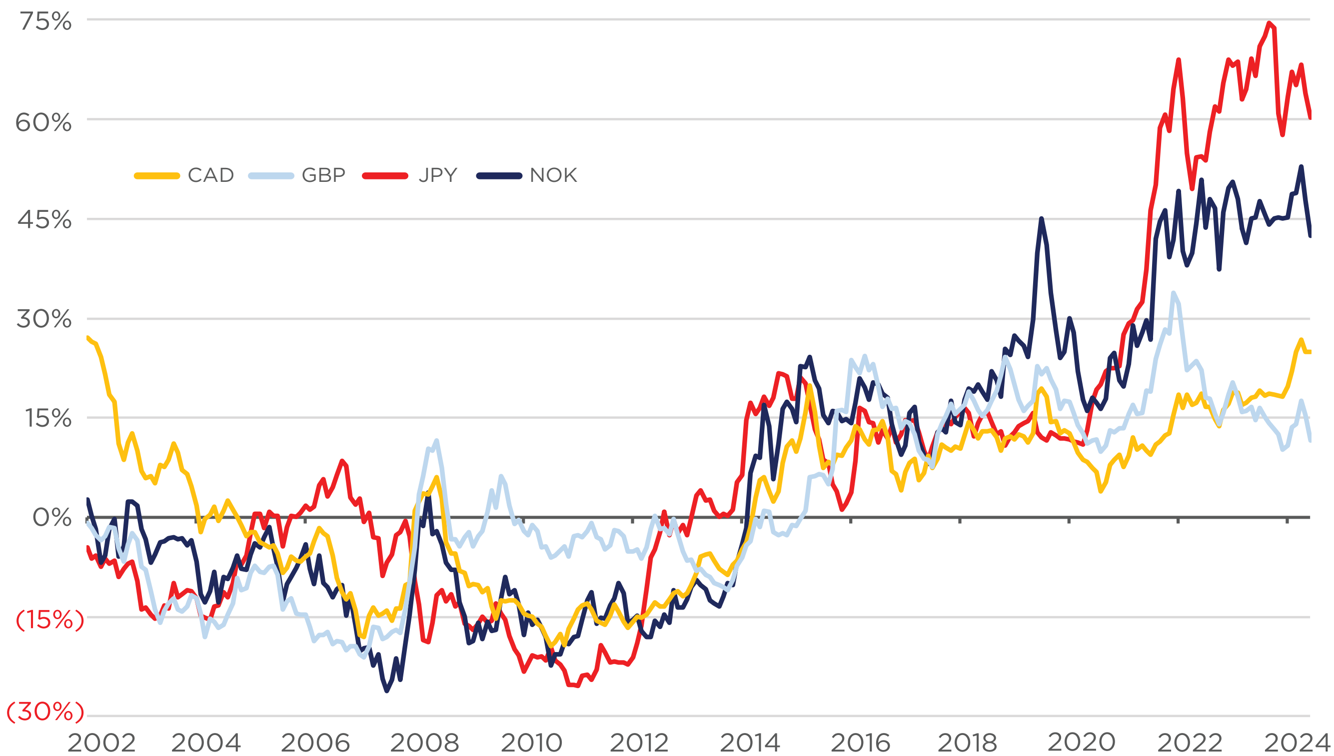


31 Mar 2025 | Source: FTSE, Orbis. Relative attractiveness is based on the median expected return difference between high-yield stocks and low-yield stocks.

On top of that, ex-US equities may also benefit from a currency tailwind. As with US stocks, "King Dollar" reigns supreme—yet another argument in favour of staying overweight the US. While it's certainly possible that the dollar will remain strong, it also looks like an increasingly risky bet to us. But on the dark side of Venus, we can find a number of neglected currencies that look substantially undervalued relative to USD (Figure 9). If the dollar loses some of its appeal—which has certainly happened at times in the past—it would be an additional tailwind for ex-US equities that we don't think is fully appreciated today.

FIGURE 9: SELECT EX-US SHARES ARE PRICED IN UNUSUALLY CHEAP CURRENCIES

Deviation from purchasing power parity value, US dollar vs selected currencies



31 Mar 2025 | Source: LSEG Datastream, Orbis. Lines show the deviation of each exchange rate from its fair value as implied by Orbis' purchasing power parity model.

CONCLUSION

In our view, investors have become so accustomed to the US market's dominance that very few can even recall a time when the roles were reversed. In our industry, a period of five years is usually enough to be considered "long term," which makes a 15-year period of outperformance seem like the normal state of affairs. Indeed, anyone who is under the age of 41 has never seen ex-US stocks outperform the US for any meaningful period of time in their professional lives. The last such episode—the "BRIC" mania of the 2000s—might as well be like studying Ancient Rome. But just because something hasn't happened for a long time in markets doesn't mean it can't happen again (Figure 10).

Sunset for US Equities?

After a long stretch of outperformance fuelled by "free money," historically high valuations, and persistent margin expansion, the US market began to underperform its ex-US peers in early 2025. Only time will tell if this trend will continue, but we believe the next 15 years are unlikely to mirror the last. These cycles can be very long, and it's not too late for investors to prepare for the possibility of a new world in which the US market is no longer dominant.

Ex-US Equities Offer a Compelling Alternative

Ex-US equities appear to have turned a corner, but they still trade at historic discounts, with some offering 5-7% dividend yields and improving fundamentals. When paired with attractive currencies, this creates a compelling alternative to US equities.

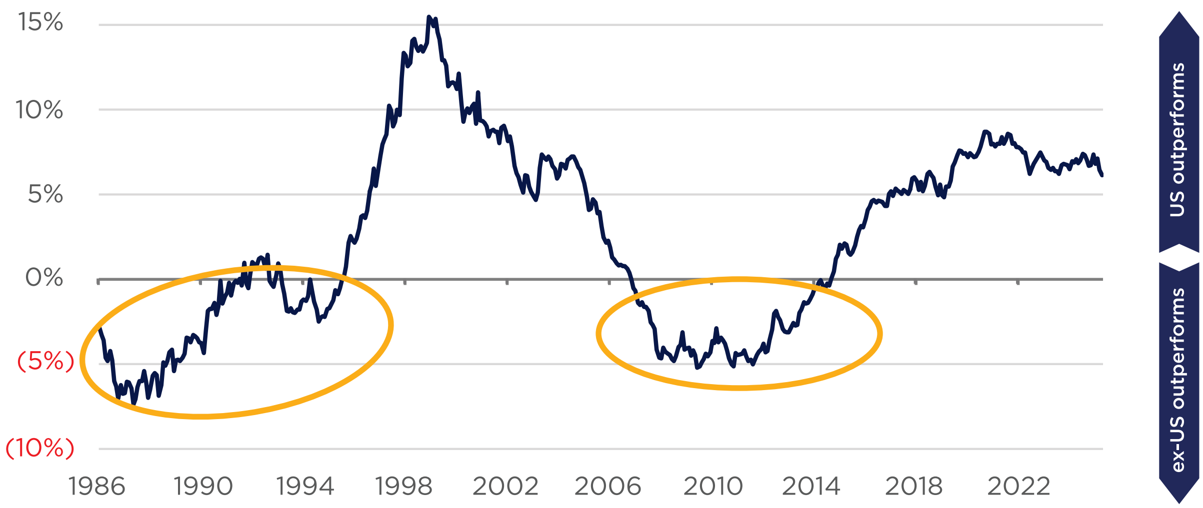
An Ideal Environment for Active Managers

Our proprietary analysis shows that 670 ex-US stocks are attractively valued versus only 140 in the U.S.—favoring managers like Orbis, who rely on rigorous research, regional expertise, and a disciplined, contrarian approach to uncover undervalued opportunities.

History shows that market cycles can be very long, and it's exciting to think we may be witnessing a new dawn for international (ex-US) equities.

FIGURE 10: THE US DOESN'T ALWAYS WIN

10-year annualised relative return of US vs world ex-US stock markets



31 Mar 2025 | Source: LSEG Datastream, Orbis. Relative total return of the DataStream US Market versus DataStream World ex-US Market indices.

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Sources (when relevant)

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