Market Update

May 2017

THE HIDDEN PERILS OF BENCHMARK VALUATIONS

Many investors have turned away from the U.S. in their quest for the most attractive global equity returns. Indeed, non-U.S. equity fund inflows were 50% greater than for U.S. stock funds through April of this year, according to Morningstar. Recently, Europe has been a common destination of fund inflows as the French election and positive economic data have driven high profile media headlines proclaiming that the region may provide better investment opportunities than the U.S. In fact, European equity funds recorded their highest ever weekly flows in early May, according to data provider EPFR Global.

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Differences Beneath the Surface

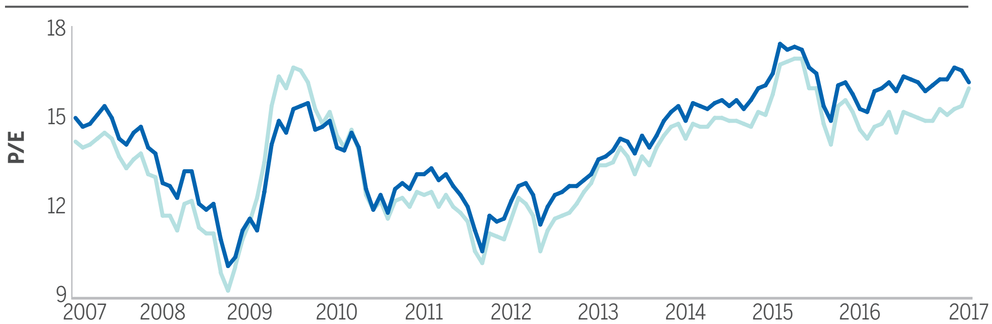
So how should investors evaluate the U.S. market versus European ones? What is the better investment: the S&P 500 Index or the MSCI EAFE Index, which has a nearly two-thirds weighting to Europe and also provides exposure to Australia and Far East Asia? As fundamental investors, we approach this question analytically with a focus on the underlying assets. Much like evaluating two homes that have similar square footage and are located in the same town, you must look at the houses' characteristics, such as neighborhoods, building materials, and amenities.

Clearly, U.S. and European indices are very different and we believe that using consolidated data to reach conclusions such as the popular refrain "Europe is cheap and the U.S. is expensive" may be problematic. While it is true that as of April 30, the MSCI EAFE traded at a 15% price-to-earnings (P/E) discount to the S&P 500, the two indices had approximately the same P/E when adjusting for sector weighting differences (see Figure 1).

The differences in sector weightings are significant. The S&P 500 has a large Information Technology overweight relative to EAFE (22.5% versus 5.7%) and EAFE has a large Financials sector overweight relative to the S&P 500 (21.4% vs. 14.1%). These variations in weightings are very important given much higher P/E multiples in Information Technology (high teens) as compared to Financials (low double digits). In our view, just as a waterfront home would command a premium value per square foot, Information Technology stocks should receive a premium earnings multiple to Financials given the following:

- Technology grows faster than Financials—14% vs. 10% based on consensus long-term EPS growth estimates for S&P 500 constituents. We believe the differential should be higher based on the quality of the growth. For example, Information Technology sector growth is more of a long-term secular trend and is based on innovation. In addition, substantive product differences exist among Information Technology companies. In comparison,

Figure 1: **Sector Neutral P/E Shows No Meaningful Valuation Discrepancy**



S&P 500 MSCI EAFE

Source: RBC Capital Markets. Adjusted for differences in sector weights.

Financials sector growth is driven more by macro factors, such as interest rates, and not by competitive differentiation among banks, credit card companies, and insurance companies.

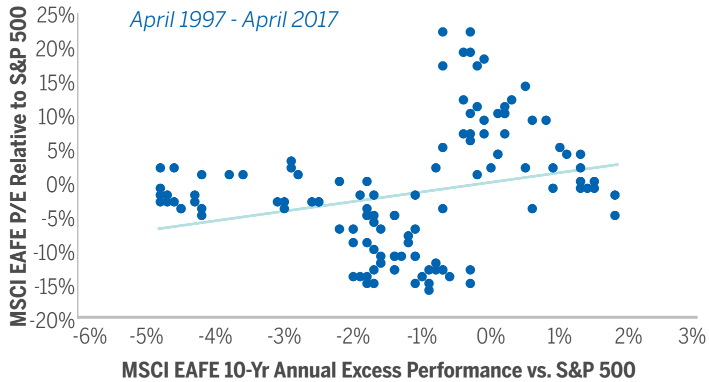
- Information Technology is more innovative than Financials. Technology products and services are dynamic and driven by high levels of innovation. The ratio of research and development relative to sales within the Information Technology sector is in the double digits compared to only low single digits for Financials. Innovative industries have the potential to grow faster than less innovative ones, and thus are more highly valued.
- Technology has higher barriers to entry than Financials. The network effects of big platform technology businesses stand in stark contrast to the commodity-like nature of banking products such as mortgages, credit cards, and savings accounts. These higher barriers often translate into higher margins and returns on invested capital, again worthy of higher valuations in the market.

Other sector weighting differences are also significant. The relatively low-multiple Materials sector represents 7.8% of EAFE compared to 2.9% of the S&P 500. Telecommunications, which is also a low-multiple sector, represents 4.3% of EAFE but only 2.3% of the S&P 500. Those differences also contribute to the overall variance of the indices' valuations. Even within sectors there are differences. For the S&P 500, the Information Technology sector has much higher exposure to the largest driver of growth—the Internet (the Internet Software & Services category has a weighting of 4.8% compared to 0.2% for the MSCI EAFE). In summary, Europe is not "cheaper" than the U.S. in any meaningful way from a top-down perspective.

The Innovation Engine

In the global equity markets it is rarely as easy as simply choosing a lower multiple stock or index for outperformance. Most of the time there is a reason for valuation discrepancies—there is no "free lunch." That is the case when comparing indices across geographies. In our view, buying geographical "markets" is like using a blunt tool in that you get varying sector and style exposures that you may not want.

Figure 2: **No Meaningful Relationship Between Relative Valuation and Relative Returns**



Source: FactSet. *Note:* P/E data is as of start of each 10-year period.

Our belief is that the most innovative companies outperform over the long-term (see The Gale of Innovation). Their strong performance likely explains the fact that there is no significant relationship between European relative valuations and returns—the U.S. innovation engine often outperforms despite its valuation premium (see Figure 2). However, while the U.S. has many of the most innovative companies, it certainly has no monopolistic hold on them. These kinds of companies exist all over the world, including Europe, but they are best identified and accessed using a bottom-up approach.

Sincerely,

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