Beyond Borders: Finding Growth Outside the U.S.

Featuring

Redwood
INVESTMENTS

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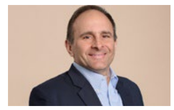

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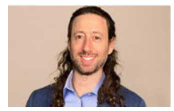

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ALEX BERNSTEIN: Hello, I'm Alex Bernstein and you're listening to The Alger Podcast: Investing in Growth and Change. Today's episode is a special one—not just because of the content, but because of the company. I'm joined by the largest group I've ever hosted in one sitting: the five-person investment team at Alger Redwood. That's Portfolio Managers Mike Mufson, Ezra Samet, Donald Smith, Alexi Makkas, and Risk and Analysis expert, Yuda Goodman.

Redwood joined Alger last year and the team now manages our international strategies, including Global Equity, International Opportunities, and Emerging Markets. Based in Boston, this team brings a research-driven, high-conviction approach to identifying growth opportunities outside the U.S.

In this wide-ranging conversation—which we're presenting in two parts—we dive into why non-U.S. markets have struggled in recent years, and how that might be changing, macroeconomics across the globe, and how investors may be missing some significant innovation stories, if they're only focused on the U.S.

Folks, thank you all so much for joining me today.

MIKE MUFSON: Thanks, appreciate the opportunity.

ALEX: To start, one of the questions we've gotten from investors, concerns the struggle that non-U.S. markets have experienced over the last three years. What do you think drove this underperformance and do you see these conditions changing going forward?

MIKE: So, the last three years have been difficult for non-U.S. investing, especially compared to U.S. equities. Probably the first things that were difficult for the non-U.S. markets had been some of the macro events and combined with very strong earnings out of U.S. companies compared to the international counterparts. However, we believe that the international stocks have become interesting from a timeliness perspective and from underlying fundamental perspective.

We think we're going from a period where the earnings growth of non-U.S. companies was significantly below the U.S., to forecasts of U.S. and non-U.S. companies having similar earnings growth rates going forward. But non-U.S. stocks trade at a meaningful discount to their U.S. counterparts.

ALEXI MAKKAS: I think one thing to add is that the U.S. in particular had been going through a very strong period of fiscal and monetary stimulus. And you can see that that's really driven U.S. valuations. Meanwhile, the rest of the globe in general has been on the other side of it. Europe for instance has been a little bit more fiscally responsible, for lack of a better term and not as stimulative where now they're in the process of easing. The inflation environment in Europe is in a much better position. And so the valuation discrepancy between the two regions, as an example, is showing as a real favorable opportunity.

DONALD SMITH: And perhaps if we rewind a little bit, thinking back about three years, the U.S. emerged from COVID kind of leading the rest of the world. China was on their own cycle. But we were pretty excited about the positive trend for Europe and some of the other emerging markets which had locked down pretty hard.

Right as we started to see the improvement from that, there was the Russian invasion of Ukraine, which really turned things upside down. It resulted in significantly higher energy prices throughout Europe. It dramatically changed supply chains. It kind of rippled through all global markets but had an inflationary impact. As fundamental analysts, we were very excited about company fundamentals and improving earnings prospects, but what happened was really a dramatic shift in a number of the macro backdrops for the companies we own.

ALEX: Against this backdrop, you think investors are simply not aware of some considerable non-U.S. opportunities?

MIKE: Yes. If you look at something like emerging markets, over the last 20 years, the compounded annual return of emerging markets isn't any different than the S&P 500. But in the last three years, the flows are almost exclusively into U.S. equity funds. It's just become very negative towards non-U.S. investing.

YUDA GOODMAN: If you go back more than three years ago, you really saw that the country mattered less for some industries than the industry. But some of the international stories that we find are just way cheaper than their U.S. counterparts.

EZRA SAMET When we think about the stocks in our portfolios, our goal isn't for our U.K. names to beat our U.K. forecast. We want to own concentrated portfolios of high conviction ideas where we think there's meaningful upside to each and every one and so the ability to generate alpha at the portfolio level is not so much related to the country but more the nature of the businesses.

DONALD: We're very fundamental research, deep research oriented and we're looking for businesses that are very resilient, durable business models that can succeed and outperform in different environments. And often these, you know, they're very well-run businesses. We take corporate governance extremely seriously, as well as management quality. We think they are businesses that can thrive and gain market share in difficult environments, because their competitors tend to get weaker. So, we can focus on finding those businesses that are exceptionally well run, that have major competitive advantages, where if we're thoughtful and do our jobs well, they'll succeed over time.

YUDA: I can add to that. It's interesting to see it especially in emerging markets, how countries could behave very differently. So, all else being equal, once we like the stock, it is interesting to see if the country would give us some kind of tailwind on the opportunity side or maybe headwind, this is where we try to mitigate some of the risks.

ALEX: Investor sentiment aside, what do you think would need to happen for a sustained rotation back to international markets?

ALEXI: I think we're starting to see some indications. We talked a little bit about Europe. But we were also looking at Russia, Ukraine. I'm not sure how it plays out, but I think we're more optimistic now that at some point there'll be some resolution.

MIKE: The rebuilding of Ukraine would be a massive capital spending program that would require years of investment. Ukraine is the population size and pretty much the land mass of California. That is a significant economy that would be driving some of the growth in Europe as well.

DONALD: And ultimately, it's earnings that'll drive the performance of our markets as they do in the U.S.

And whether you're looking at energy or geopolitics or some of the changes that have happened in Europe, there's impediments that are being taken out of the way that we think would allow earnings growth to pick up.

EZRA: I think that's true in Japan as well. Improving corporate governance and normalizing macro economy lead to the potential for rising earnings and the returns on capital and returns on equity, all of which should drive earnings and then the multiples that people assign to those earnings higher over time.

ALEX: You already mentioned a couple of headwinds and tailwinds. Are there any others you foresee for this kind of turnaround?

DONALD: One of the headwinds for China over the last three years has been a number of self-inflicted, let's call them impediments to growth, whether in Internet crackdown, the government really focusing on depressing what they viewed as a property bubble.

While China is a small part of the international landscape in terms of indexes, the impact of it as the second largest economy and the growth impulse on the rest of the world is meaningful. And, as an example, China consumes over half of the world's copper. And that's been a headwind for exporters, for Europe, all its Asian neighbors. And we've started to see stabilization and maybe even green shoots now.

MIKE: The valuation of the Chinese market has declined precipitously over the past almost 20 years, especially relative to the United States. So, it's looking at this point at about a trough valuation as it's been in many, many years.

ALEXI: Another potential tailwind that may be emerging is just energy prices. We're coming off of a shorter term elevated level, especially in natural gas and oil. It's provided a substantial headwind to consumers and to corporates globally. And there's a bit of a global energy renaissance emerging right now, particularly in natural gas. And that could drive a better set up for a tailwind from energy prices.

ALEX: I wanted to pivot to the subject of growth and innovation which I know is so important to Alger investors. You believe that there's a tremendous amount of innovation happening outside of the U.S. that U.S. investors are just simply not aware of. Can you give some examples?

MIKE: I'll start with one area, which is in healthcare. Contract development and manufacturing organizations or DCMOs are very important companies in drug manufacturing and developing drugs and getting them to the market faster. These companies are located outside the United States. The leaders, one is in Korea, and one is in Switzerland. And we believe they have a big opportunity because drug companies throughout the world have recognized that manufacturing is a critical aspect to what they do. They've been world class at R&D, but they've not necessarily been world class at manufacturing. And we're moving into much more complex molecules, biologics, cell and gene therapy, antidrug coagulants. All of those that require a more challenging manufacturing process and that requires a more sophisticated company to be involved. And that is an area where we think there could be many years of higher pace of growth because of the sophistication required that these companies can provide.

DONALD: Another area with growth outside of the U.S. is banks, which tend to be in emerging markets. These are companies that tend to be in rapidly growing economies, over five percent GDP growth. And they're either businesses that have a foundation with ultra strong deposit franchises that are able to grow loans between 10 and 20 percent compounded over the last 20 years, are exceptionally well capitalized, over 20 percent ROEs, and that are more digital based.

We think these are well-capitalized companies, extremely well-run businesses that are often attacking growing markets and that are populated by largely public sector banks that are not run for profitability and efficiently. So better efficiency ratios, strong growth, very good returns, and companies that we think are well-run with a long runway of growth in front of them.

If you go look at Mexico as an example, the unbanked population is over 75 percent of the local population. So, even the banking of this group is a huge growth driver of that market.

EZRA: One other area of innovation outside of the United States is China. And specifically, around some of those social media and internet businesses there. Businesses like Tencent and Alibaba and Meituan and maybe TikTok as the obvious and most glaring example, the parent company, Douyin, have really innovated around how e-commerce is done, how social media is done at incredibly large scale. And now we see some of these consumer behaviors and actually some of these platforms expanding globally and bringing those value propositions to consumers in America and the rest of the world.

MIKE: I'd be remiss if we didn't mention maybe the largest market cap company outside the United States as far as innovation. So, there are nine trillion dollar market cap companies in the world, seven located on the West Coast of California. Then there's Saudi Aramco and the last one is Taiwan Semiconductor. And Taiwan Semiconductor is an incredibly innovative company. And their importance to the semiconductor manufacturing community, we think, is of extreme importance. And we think this is a company that can grow for many years.

ALEX: Last question, and I'll just throw this out to all of you. Why do you personally think that U.S. investors should come back to non-U.S. investments?

DONALD: We're having maybe a biased view as an international investor, but the inefficiencies outside the U.S. are significant. And as investors who are looking for the best companies where earnings are underappreciated, spectacular businesses with business models that we expect to be successful not just on a multiyear basis, but potentially with a 10, 20 year opportunity. The international markets, for a number of reasons, are more fragmented and just offer opportunity that's very exciting. So, we've kind of made our bed and this is talking our own game to a degree. But the markets are exciting. There's opportunities even when macros are against us, we're finding businesses that we want to own.

ALEXI: I would say, just briefly ex-U.S. is generally mispriced to a greater degree than U.S. companies or equities. They're now historically mispriced and as we talked, we're starting to see some emerging tailwinds, green shoots, however you want to term it. And the combination of those two playing out could set us up for an extended period of relative performance.

YUDA: Home country bias exists everywhere. In the U.S. people who have home country bias definitely enjoyed it in the past few years. If markets are less efficient, there is much more room for active investment.

MIKE: Don mentioned the fundamentals are improving and Alexi talked about how the valuation is excellent and Yuda talked about how there's opportunity for active investors. And the timeliness around that might be the fact that the sentiment is so negative towards non-U.S. investing that as that improves with improving fundamentals and a cheap valuation, it makes it a very timely place to be an investor.

ALEX: Fantastic. Thank you all so much.

ALL: Thanks, Alex. Great talking with you.

ALEX: And thank you for listening. Please don't forget that this is just part one of our conversation with the Redwood team, and we'll have part two available for you in a couple weeks. Until then, for more information about Alger Redwood international products, and for more of our latest insights, please visit www.alger.com.

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