William Blair

GLOBAL EQUITY

Investment Management
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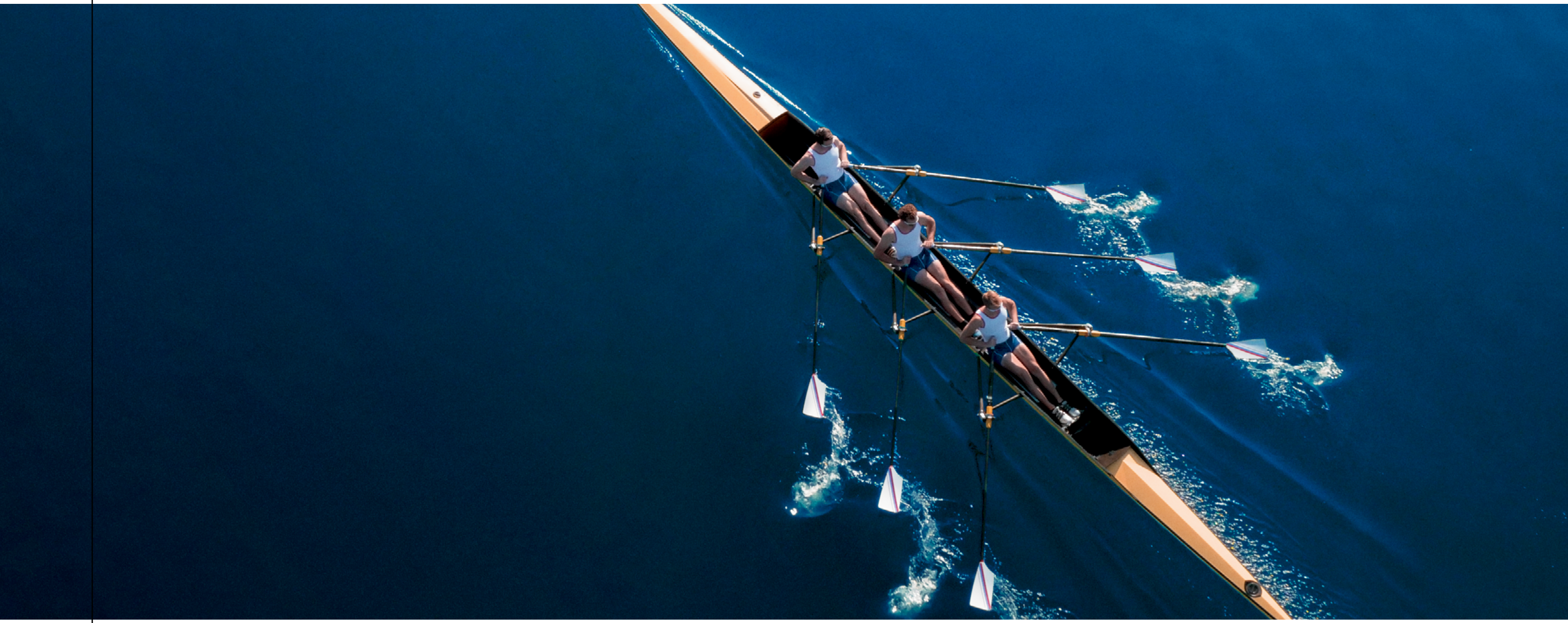
Three Pillars of International Investing



Today's investors may be handicapping their return potential by not considering international stocks, which remain an important part of a diversified equity portfolio. An active approach to international investing unlocks a broad opportunity set, allowing investors to search for the best investment ideas around the world. We believe portfolios constructed with this in mind have the potential to deliver superior risk-adjusted returns.

December 2020

Portfolio Manager, Global Research Analyst
Alaina Anderson, CFA, Partner

Introduction

Alaina Anderson, CFA, Partner

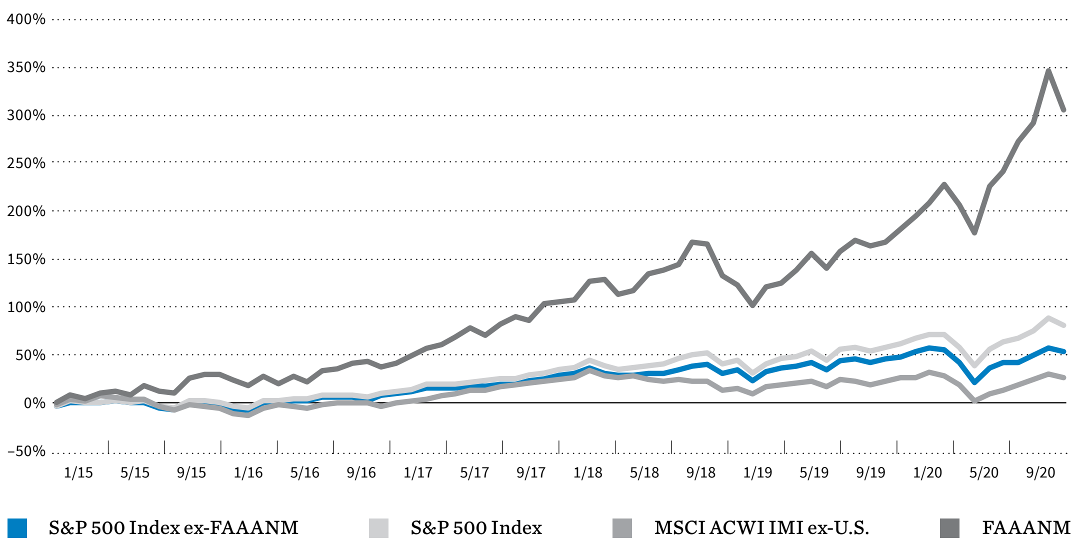
U.S. equity markets have significantly outperformed international equity markets since the Global Financial Crisis (GFC), leaving some investors hesitant to diversify outside the United States. But the outperformance of U.S. equities has not been broad. Investors should consider the elements of this outperformance—namely, the fact that it has been highly concentrated.

While the S&P 500 Index has outperformed the MSCI All Country World Index (ACWI) ex-U.S., much of that outperformance can be explained by a few key stocks, mainly in the information technology (IT) sector, as exhibit 1 illustrates.

EXHIBIT 1

S&P 500 Index Performance Driven by FAAANM Stocks (Cumulative Returns)

The performance of the S&P 500 Index has been driven by a few key stocks, including those referred to as "FAAANM"—Facebook, Apple, Alphabet, Amazon, Netflix, and Microsoft.



Sources: IDC and William Blair, as of 9/30/20. **Past performance is not indicative of future returns.** Indices are unmanaged and do not incur fees or expenses. A direct investment in an unmanaged index is not possible.

"While the S&P 500 Index has outperformed the MSCI ACWI ex-U.S., much of that outperformance can be explained by a few key stocks, mainly in the IT sector."

Alaina Anderson, CFA, Partner

Introduction (continued)

While growth and returns in the U.S. IT sector relative to the non-U.S. IT sector might have at one time foreshadowed the strong outperformance we have seen, that dynamic has shifted. U.S. IT sector growth and return expectations have declined on an absolute and relative basis when measured against the non-U.S. universe, as exhibit 2 illustrates. In fact, as we will discuss later, we believe the outlook for growth and returns in aggregate across all sectors is more favorable for international equities than domestic equities.

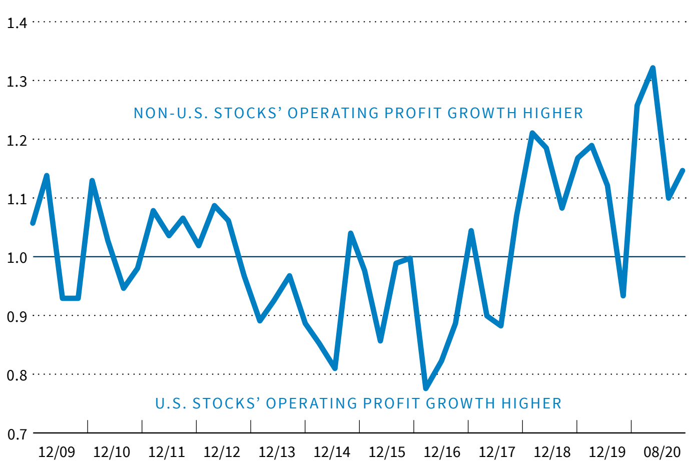
This narrowing of growth in the United States may be a signal for concern given the lack of diversity across sectors, market capitalizations, and corporate lifecycle. Investors may be handicapping their return-generation potential by not investing internationally. We base this thesis on three pillars:

1. Company-specific factors, including what we call "sustainable value creation," are increasingly more important than country-specific factors, and companies that deliver strong sustainable value creation are increasingly found outside the United States.
2. Additionally, expectations for earnings growth and return on invested capital (ROIC) have become more favorable outside the United States—and our outlook for growth in key industries suggests accelerating demand and emerging business models abroad.
3. The regulatory environment outside the United States is more conducive to the proliferation of disruptive business models.

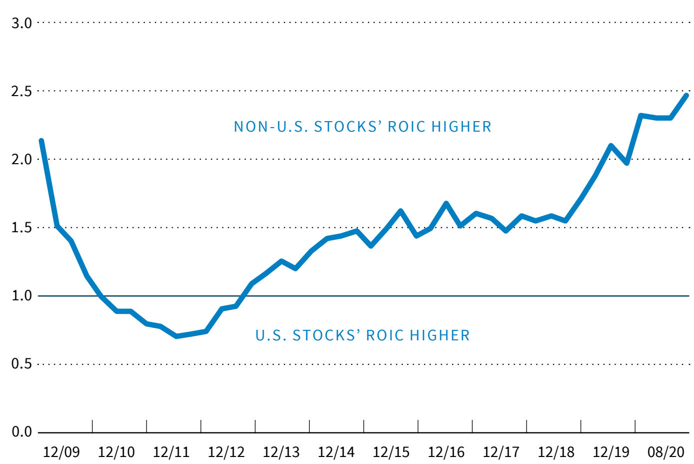
EXHIBIT 2

IT Sector Growth and Returns Have Shifted in Favor of the Non-U.S. Universe

The U.S. IT sector's growth and return on invested capital (ROIC) have declined on an absolute basis as well as relative to the non-U.S. universe. The charts below show the spread between U.S. and non-U.S. stocks.



MSCI ACWI IMI ex-U.S. IT Sector vs. Russell 3000 Index IT Sector: NTM Operating Profit Growth



MSCI ACWI IMI ex-U.S. IT Sector vs. Russell 3000 Index IT Sector: ROIC

Sources: Worldscope, IBES, and William Blair, as of 9/30/20. **Past performance is not indicative of future returns.** NTM is next 12 months.

> "We believe investors interested in growth should consider investing internationally"
>
> **Alaina Anderson, CFA, Partner**

In addition, while investors are understandably hesitant to consider non-U.S. investing given geopolitical tensions that imply a movement toward deglobalization or slowbalization, this dislocation is not without upside. In fact, there has been an acceleration of the repatriation of intellectual capital, investment in local supply chains, and the emergence of domestic champions offshore. This has created, for international investors, a growing opportunity set for portfolios.

An active approach to identifying high-quality growth investments outside the United States has the potential to unlock a broad opportunity set, allowing investors to search for the best investment ideas around the world. The use of a wide aperture in identifying high-quality growth investments, regardless of region or country of domicile, may lead to portfolios with heightened conviction, lower turnover, and higher risk-adjusted returns than constraining the focus to a narrower mandate.

In the following pages, we discuss these three key pillars and how they inform our thesis—that investors interested in growth should consider investing internationally. Leveraging these ideas to gain insight into where global profit pools are growing and constructing portfolios from those ideas could result in strategies that deliver superior risk-adjusted returns.

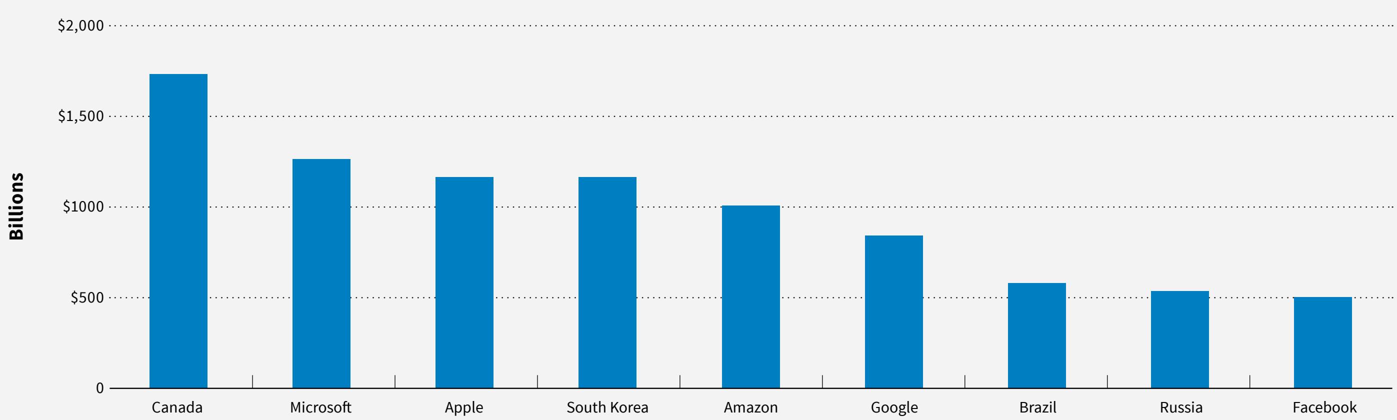
Alaina Anderson, CFA, Partner
PORTFOLIO MANAGER, GLOBAL RESEARCH ANALYST

The strong performance of FAAANM stocks presents interesting opportunities for comparison. For instance, the combined market capitalizations of a few key companies are greater than the gross national product (GNP) of several major economies, as exhibit 3 illustrates.

EXHIBIT 3

How Big Are Apple, Amazon, Facebook, Google, and Microsoft?

The combined market capitalization of Apple, Amazon, Facebook, Google, and Microsoft is greater than $4 trillion—more than the combined market capitalization of the stock markets of Canada, South Korea, Brazil, and Russia.



Sources: Bloomberg and William Blair, as of 4/7/20. Country market capitalizations are represented by the corresponding Bloomberg exchanges.

1. The High-Quality Universe Is Broader Outside the United States

Company-specific factors, including what we call "sustainable value creation," are increasingly more important than country-specific factors, and companies that deliver strong sustainable value creation are increasingly found outside the United States.

The universe of high-quality growth stocks outside the United States is large and growing, and this is important because quality—specifically, what we call sustainable value creation—is a far more significant contributor to equity returns than other factors, such as geography.

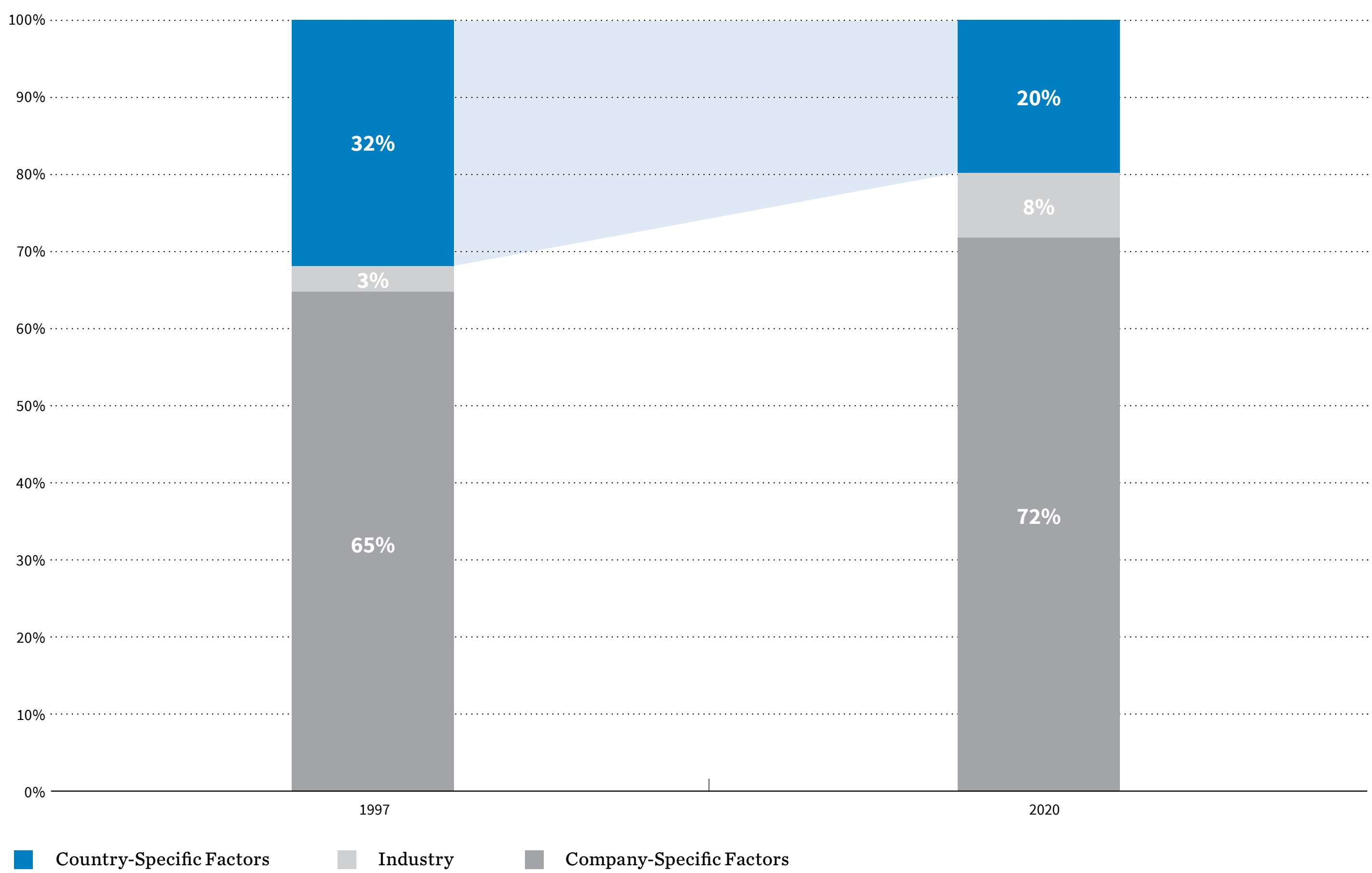
Our analysis indicates that while country-specific factors have historically had a nearly 30% impact on investment returns, the importance of country-specified factors on investment returns has declined over time, and company-specific factors have emerged as the dominant component of investment returns. Exhibit 4 illustrates.

Among those company-specific factors are sustainable value-creation characteristics, such as industry-leading ROIC and sustainable competitive advantages. We believe portfolios constructed with meaningful allocations to companies that exhibit strong, sustainable value-creation characteristics have the potential to generate strong absolute and relative returns as well as superior risk-adjusted performance.

EXHIBIT 4

Effect of Country-Specific Factors on Investment Returns Has Declined

While country-specific factors have historically had more than a 30% impact on investment returns, their importance to investment returns has declined over time. At the same time, company-specific factors have become more important.



Source: William Blair as of 9/30/20. **Past performance is not indicative of future returns.** Universe is the MSCI ACWI IMI. Data is from the baraGEMLT risk model and shows group-level volatility smoothed using a two-year moving average.

1. The High-Quality Universe Is Broader Outside the United States (continued)

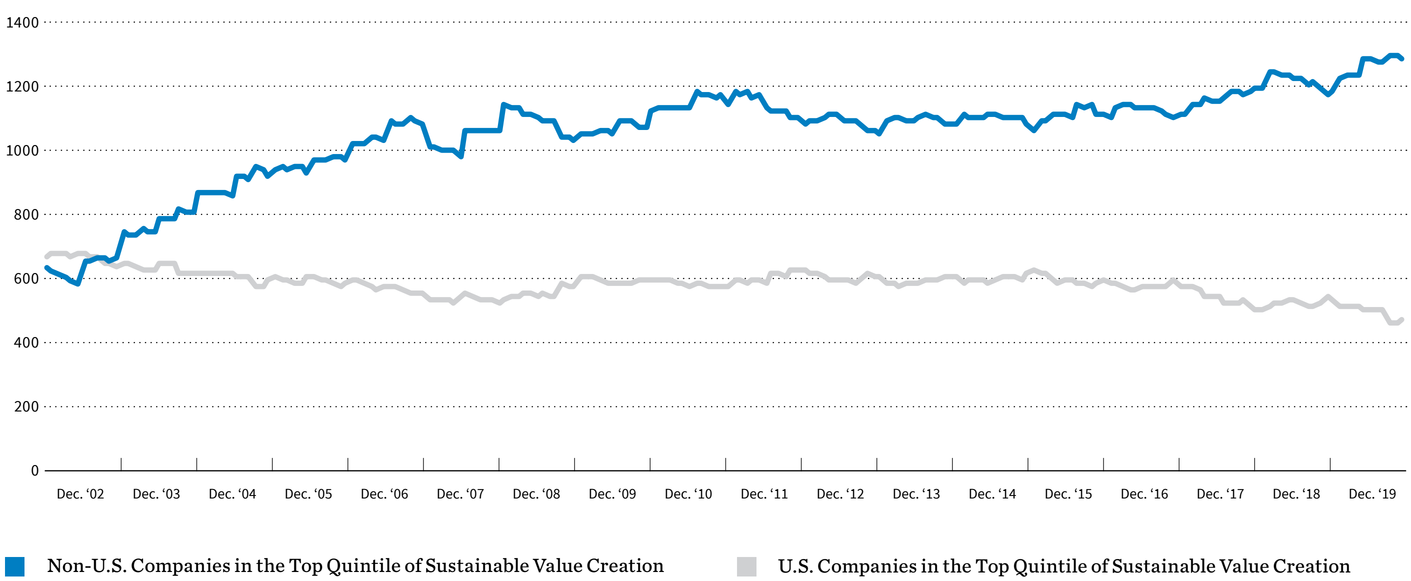
Increasingly, these companies can be found outside the United States, as exhibit 5 illustrates. The evolution of professionalization and innovation abroad has led to a material increase in the number of sustainable value creators in both developed and emerging markets.

For example, we find pharmaceuticals, luxury, and renewables to be industries with high exposure to companies with strong sustainable value creation characteristics. Interestingly, our analysis shows that the total market capitalization of pharmaceutical companies outside the United States is nearly two times the size that it is inside the United States. The disparity in luxury and renewables is even more remarkable: the non-U.S. luxury goods universe is seven times the size of the U.S. universe, and the non-U.S. renewable energy universe is six times the size of the U.S. universe.

EXHIBIT 5

More Non-U.S. Companies Are in Top Quintile of Sustainable Value Creation

The proportion of non-U.S. companies in the top quintile of sustainable value creation has increased from 50% nearly 20 years ago to nearly 75% today. We believe portfolios constructed with meaningful allocations to companies with sustainable value-creation characteristics have the potential to generate strong risk-adjusted performance.



Source: William Blair, as of 9/30/20. Universe is the MSCI ACWI IMI. Sustainable value creation is a factor within the William Blair quality model, which attempts to put into quantitative terms one of the cornerstones of the firm's investment philosophy: identifying high quality companies. The score combines measurements of sustainable value creation, earnings quality, and financial strength.

1. The High-Quality Universe Is Broader Outside the United States (continued)

In short, we believe investors increase their potential to earn superior risk-adjusted returns by fishing in ponds that are teeming with creators of high sustainable value—and the ponds are increasingly outside the United States.

> "We believe investors increase their potential to earn superior risk-adjusted returns by fishing in ponds outside the United States."
>
> **Alaina Anderson, CFA, Partner**

EXHIBIT 6

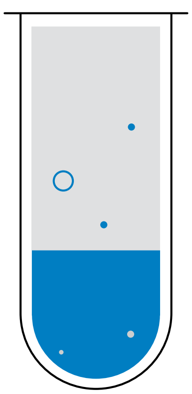
Opportunity Set in Key Industries Is Larger Outside the United States

The opportunity set for many growth industries is significantly larger outside the United States, as illustrated by aggregate market cap (in millions).

Pharmaceuticals

Non-U.S.
63% ($2,183,949)

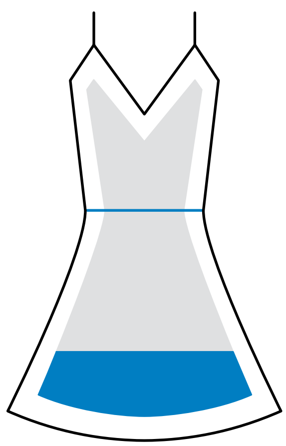
U.S.
37% ($1,296,767)



Apparel, Accessories, and Luxury Goods

Non-U.S.
86% ($700,919)

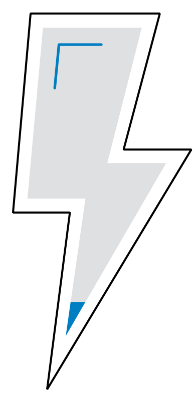
U.S.
14% ($116,855)



Renewables

Non-U.S.
87% ($181,121)

U.S.
13% ($27,113)



Sources: IDC and William Blair, as of 8/31/20. Non-U.S.stocks are represented by the MSCI ACWI IMI ex-U.S. Index. U.S. stocks are represented by the Russell 3000 Index. Renewables fall with the GICS classification Independent Power Producers and Energy Traders.

2. The Tide Is Changing

The expectations for earnings growth and return on invested capital (ROIC) have become more favorable outside the United States—and our outlook for growth in key industries suggests accelerating demand and emerging business models abroad.

An analysis of aggregate growth and returns outside the United States versus inside the United States provides some insight into the performance differential we have seen over the past decade—and may provide some insight as to what may come.

Ten years ago, the growth outlook for U.S. and non-U.S. growth stocks was similar. However, U.S. companies were better positioned in terms of ROIC. The implication was that U.S. companies could enjoy higher returns for every dollar invested in their businesses. Over a short period, this return differential manifested in U.S. companies' ability to make large investments in new technologies, acquire adjacent businesses, and enter new markets at a more rapid pace than their offshore brethren.

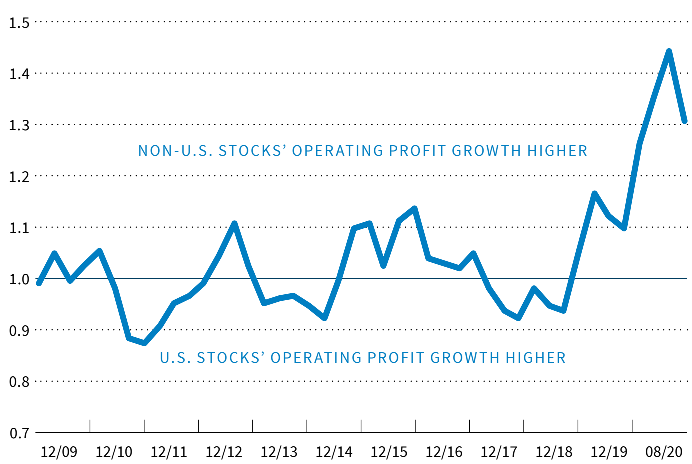
What we see now portends a similar such outlook for the growth of non-U.S. companies. Specifically, returns (as measured by ROIC) of non-U.S. companies are approximately 30% better than those of U.S. companies. In addition, the forecast growth of non-U.S. companies is faster, based on analyst estimates. This means that non-U.S. companies should not only benefit from greater compounding than U.S. companies, but the dollars available for investment should be greater as well—creating a strong cycle of sustainable value creation, as exhibit 7 illustrates

> "Returns of non-U.S. companies are approximately 30% better than those of U.S. companies."
>
> **Alaina Anderson, CFA, Partner**

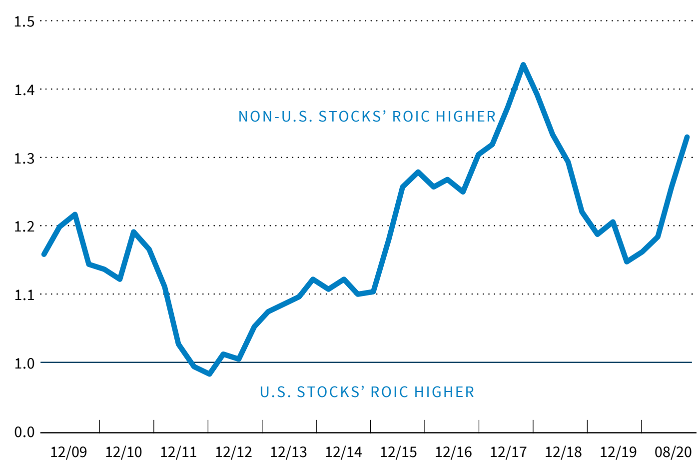
EXHIBIT 7

Growth and Return Differentials Show Non-U.S. Companies Outperforming

Ten years ago, the growth outlook for U.S. and non-U.S. growth stocks was similar. However, U.S. companies were better positioned in terms of ROIC. What we see now portends a similar such outlook for the growth of non-U.S. companies. The charts below show the spread between U.S. and non U.S. stocks.



MSCI ACWI IMI ex-U.S. vs. Russell 3000 Index: NTM Operating Profit Growth



MSCI ACWI IMI ex-U.S. vs. Russell 3000 Index: ROIC

Sources: Worldscope, IBES, and William Blair, as of 9/30/20. **Past performance is not indicative of future returns.** NTM is next 12 months.

In particular, the outlook for growth in key industries is more attractive outside the United States and, we believe, will result in accelerating demand and emerging business models abroad. IT services, digital payments, and renewables are examples of industries in which growing demand and the emergence of new business models drive a stronger growth outlook abroad.

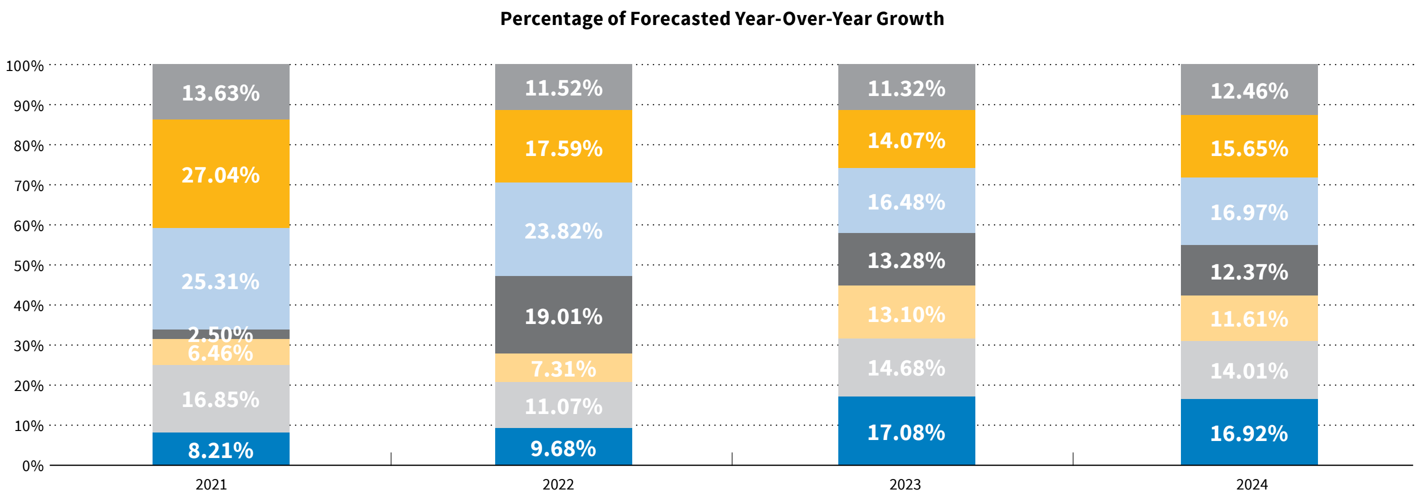
IT Services/Enterprise Software

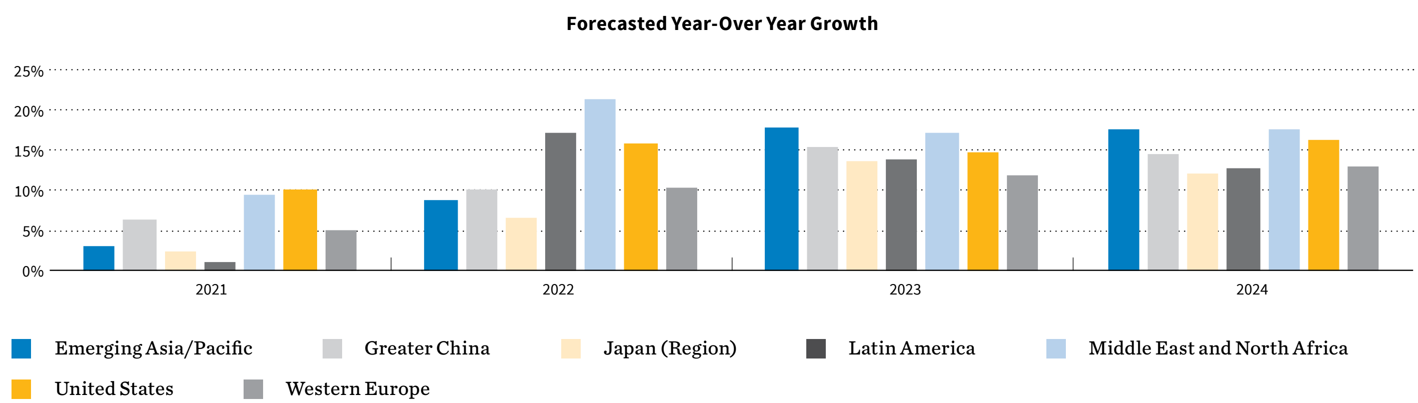
The concentration of IT inside the United States is high and has buoyed index returns. However, we are seeing an increased emergence of new technology applications outside the United States. The spread of at-home work could have significant investment implications, *as our blog post explains*.

EXHIBIT 8

Non-U.S. Companies Dominate in Enterprise Application Software

Companies that may see an increase in demand include firms that offer remote-work platforms with features such as security and file sharing. Our analysis indicates that the non-U.S. share of growth in this industry is expected to increase from 70% to 85% as the growth rate of earnings of non-U.S. companies is expected to outpace that of U.S. companies.





Sources: William Blair and Gartner, as of 4/30/20.

Companies that may see an increase in demand include IT service providers that help other firms implement and scale remote-work platforms and firms that offer remote-work platforms with the features that enterprises want and need (such as security and file sharing).

IT spending in certain countries could also accelerate. Japan's IT infrastructure, for instance, is still about 5 to 10 years behind that of the United States and Europe, so IT spending may be needed there to support remote work. We are paying close attention to how this innovation could play out globally, especially around telehealth and distance learning.

Payments

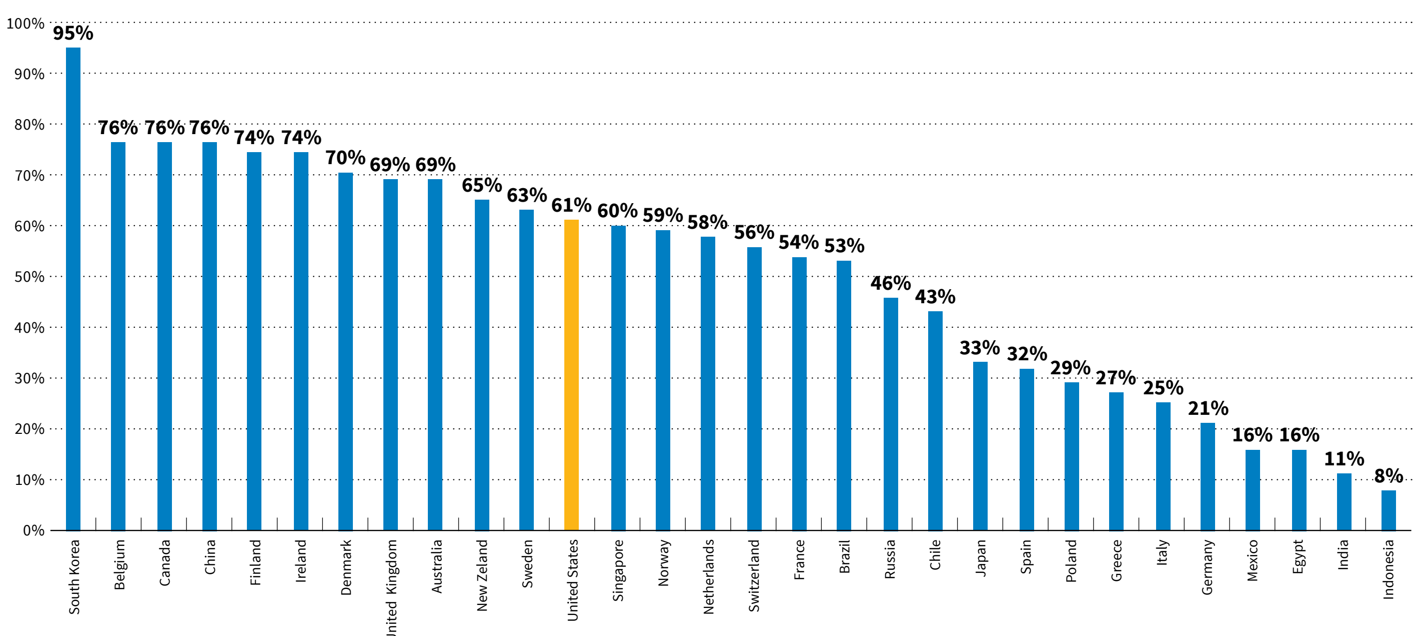
As we explain in a blog post, the *digital payments industry represents a truly enormous addressable market* that continues to expand due to strong, durable secular tailwinds. But the industry is also compelling because penetration varies significantly across regions and countries, creating opportunities for fundamental managers to find value.

For example, the United States is a more mature market with high penetration levels, while usage in Europe varies drastically by country. In emerging markets, penetration is typically low, providing a long runway for growth. Country-specific differences, shown below, provide insights into the nature of various opportunities around the world.

EXHIBIT 9

Digital Payment Penetration Levels Around the World

Driven by forces such as increased internet access and mobile phone adoption, the growth of e-commerce, government policy, as well as globalization and demographic trends, the ongoing shift toward noncash transactions can be seen around the world.



Sources: Euromonitor International 2020, Credit Suisse, and William Blair, as of 2019. Values are consumer card payment transactions as a percentage of total consumer payment transactions, and are at historical 2019 prices, forecast constant 2019 prices, and historical fixed 2019 exchange rates and forecast fixed 2019 exchange rates.

Renewables

A Bloomberg New Energy Finance study released in June 2019 projected that at present trends, the world will move from sourcing two-thirds of its energy from fossil fuels in 2018 to two-thirds zero-carbon energy by 2050, with wind and solar supplying nearly half of the world's electricity by then. Coal-fired energy will fall by 51%, the study estimates, supplying just 12% of world electricity.

While *the United States is a hive of renewable energy*, *it is no longer the world leader*, as our blog posts explain. China is the top investor in clean energy today, while Europe leads in adopting renewable initiatives. Of the nearly $290 billion invested in renewable energy in 2018 worldwide, China accounted for most of it at $91 billion, according to a 2019 study published by REN21, a global renewable-energy think tank.

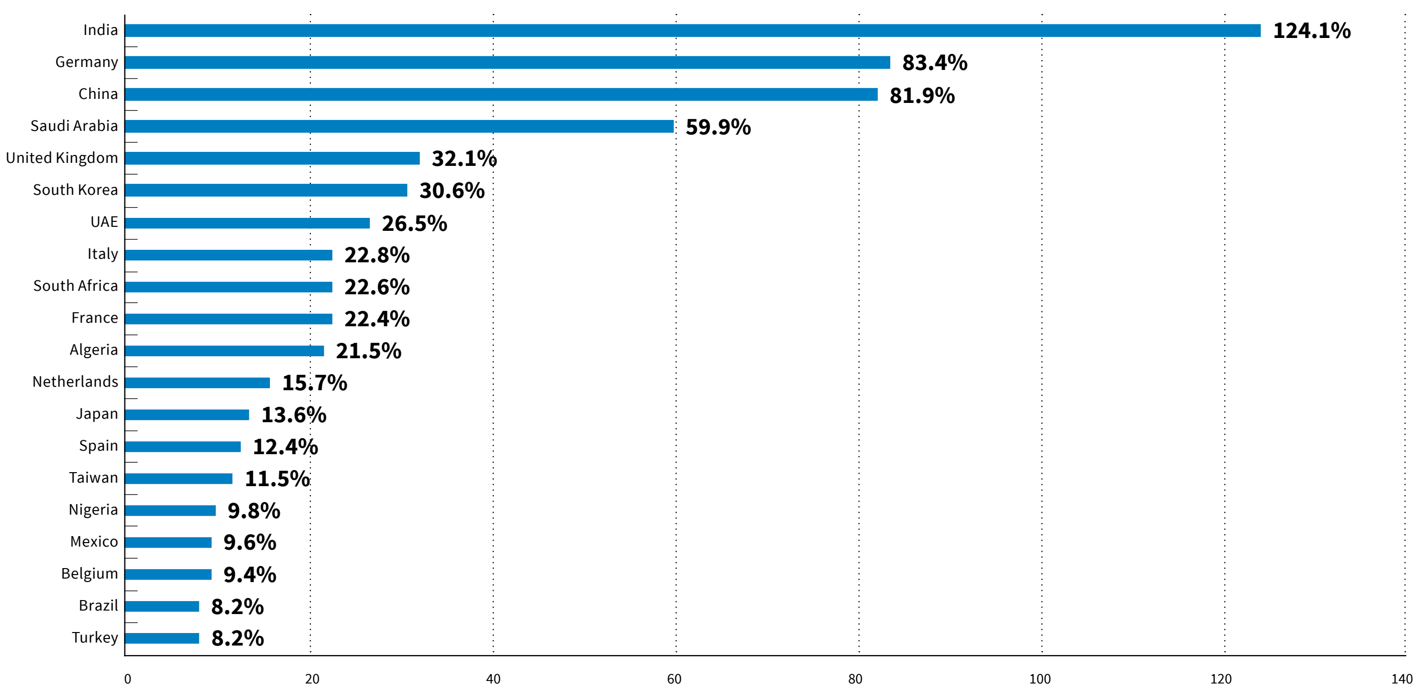
There are days in Germany when the cost of wind power is zero because of how efficient the wind farms have gotten and how much supply there is when it is windy. In the United Kingdom, there are even days when the country uses no coal-based power. The United Kingdom is also implementing policies whereby only electric vehicles will be allowed in certain parts of the nation.

As renewable energy has become more efficient and competitive, more and more companies—NextEra, Neste, Enel, and Orsted, to name a few—say they will continue to expand their renewable energy business because it is good for their bottom lines as well as the environment.

EXHIBIT 10

Non-U.S. Countries Should Lead Demand for Renewable Power Additions (in Gigawatts)

Countries outside the United States lead when it comes to renewable power additions required to meet government targets between 2020 and 2030.



Sources: "Global Trends in Renewable Energy Investment 2020," UNEP, Frankfurt School-UNEP Center, BloombergNEF and William Blair, as of 2020. Includes solar PV, onshore and offshore wind, biomass and waste, and geothermal. For targets based on electricity consumption or generation, the equivalent volume of capacity was devised based on BloombergNEF's New Energy Outlook 2019 estimates for future demand and capacity factors for the relevant technologies.

3. Disruptive Business Models Can Thrive Outside the United States

The regulatory environment outside the United States is more conducive to the proliferation of disruptive business models.

Financial technology (fintech) is driving long-term shifts, such as the move toward card and even person-to-person payment—and these trends are likely to underpin above-average industry growth. Indeed, much of the digital innovation of the past decade has taken place in the financial services sector.

However, the U.S. regulatory environment has proved a hindrance to innovation in this area, with an increasing amount of fintech innovation coming from abroad.

The past two decades have seen a rise in the number of new data protection laws and privacy regulations, and organizations must often comply with more than one regulation spanning different geographies and focusing on different capabilities.

This is especially true in the United States, where there is a morass of complicated regulation. Try to imagine, for example, how difficult it would be for a conventional financial institution to dip its toes in the cryptocurrency industry.

There has been more innovation in international markets, where compliance requirements under the Bank Secrecy Act and other anti-money-laundering regulations are clearer. Europe, in particular, is doing well in financial technology as well as robotics and 5G.

Moreover, slowbalization could create local champions, as William Blair's *Ken McAtamney has discussed* in a blog post.

> "The localization of supply chains is creating local champions as companies with close proximity to consumers gain share."
>
> **Alaina Anderson, CFA, Partner**

As Ken explained, globalization is a long-term phenomenon. The past 40 to 50 years have been an era of liberalization of economic policies. A confluence of forces on both the supply and demand sides have favored this trend. This has supported global growth and shaped the landscape for winners and losers in corporate performance.

Over the past few years, however, we have seen many of these forces challenged and in some degree reversed as the undercurrents of socioeconomic imbalances, nationalism, and populism reveal themselves in trade and tariff changes and even corporate supply chains. The Economist refers to this as slowbalization, *as discussed in depth in our podcast*.

It will be interesting to see if institutions worldwide rise to the challenge and work together to solve the problem, leading to a flattening of the world, or if we will see retrenchment into this trend of national interest that takes precedent over all else.

In the meantime, we have witnessed global supply-chain disruptions and the repatriation of intellectual capital and expertise. The localization of supply chains is creating local champions as companies with close proximity to consumers gain share.

Conclusion: Dynamics Could Favor International Investing

In summary, the past 10 years of leadership in U.S. equity performance was earned by a unique set of companies employing specific business models that benefited from a specific set of tailwinds.

Our analysis indicates that the tide is changing. Growth and returns dynamics that supported the outperformance of U.S. companies now seem to support a more constructive outlook for companies outside the United States. In addition, our survey of global growth indicates that industries where we find growing profit pools are larger and growing more rapidly abroad.

> "We believe the outlook for the next 10 years favors investments outside of the United States."
>
> **Alaina Anderson, CFA, Partner**

We believe the outlook for the next 10 years favors investments outside of the United States. From company-specific factors (such as sustainable value creation) to exogenous factors (such as a favorable regulatory environment), in our opinion the intermediate-term growth and return dynamics in listed equities favors international investing.

About William Blair
William Blair is committed to building enduring relationships with our clients and providing expertise and solutions to meet their evolving needs. We work closely with most sophisticated investors globally across institutional and intermediary channels. We are 100% active-employee-owned with broad-based ownership. Our investment teams are solely focused on active management and employ disciplined, analytical research processes across a wide range of strategies. As of September 30, 2020, we manage $61.7 billion in assets. We are based in Chicago with resources in New York, London, Zurich, Sydney, Stockholm, The Hague, and Singapore[1] and dedicated coverage for Canada.

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