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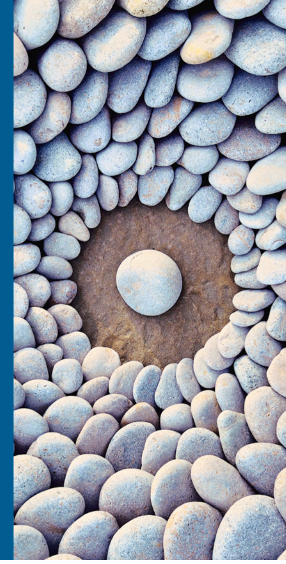

Global Equity Observer

Compound interest

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The market had a very strong first quarter (Q1), with the MSCI World Index up 9%, on the back of the 11% rise in the previous quarter. The market rise has been about multiples rather than earnings, with the MSCI World Index at 18.6x the next 12 months earnings, versus the 13.7x trough in September 2022. This is close to the peaks reached during the COVID earnings slump and 10% above the highest multiple of 17x reached between 2003 and 2019.[1]

The forward earnings number has been edging upward, gaining 2% year-to-date and 8% in the last year.[2] However, this is not due to an improving outlook, given that forecasts for 2024 and 2025 are flatlining, but instead due to the passage of time moving higher estimates to later years.

These "higher later" earnings also make us nervous, as they are dependent on margins rising from already high levels, given 10% per year earnings growth on sales that are expected to be up less than 5% per year. The MSCI World's EBIT (earnings before interest and taxes) margin is expected to go from an already peaky 15.7% in 2023 to 17.2% by 2025. As ever, there are only two ways of losing money in equities, either the earnings going away or the multiples going away—and right now we are worried about both.[3]

2023 was the story of the "Magnificent Seven". The Seven have diverged in 2024, with talk of the "Fabulous Four", but it is really the "Omnivorous One", the American graphics processing unit and chip systems company, up another 89% in Q1 to a $2.3 trillion market capitalisation on the back of 2023's 239% return. For anyone benchmarked against the MSCI World Index, not owning this company cost 151 basis points (bps) of relative performance in Q1 2024,

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[1] FactSet, April 2024.
[2] FactSet, April 2024.
[3] FactSet, April 2024.

on top of 155 bps in 2023, a relative hit of over 300 bps in 15 months. The largest five stocks now make up 17% of the MSCI World and tend to be both fairly volatile and correlated.[4]

This combination of ebullient and concentrated markets makes for a challenging investment environment, particularly in relative terms. Our response is to continue to think in absolute terms and look to compound over the long run.

Looking forward, we aim for the companies in our global portfolios to continue to compound at around 10%. The ambition is that the portfolio companies' revenues should grow reliably at 5%-6% across the cycle, incremental improvement in margins should add another 1%, while the 4% free cash flow yield, helped by the near 100% free cash flow conversion, completes the picture. Assuming half of the free cash flow is paid out as dividends and the rest boosts earnings-per-share (EPS) either through buybacks or acquisitions, this implies around 8% EPS growth for the portfolio, with a 2% dividend yield taking the overall compounding to 10%. We are not convinced that the market will match this compounding ability. It can keep up in the good times but is likely to suffer more heavily in the bad times. The worry is that after 15 years without a recession, barring the brief interregnum of COVID, the bad times may be on the way, though signs of an imminent U.S. recession are fading.

Future portfolio returns are not just from compounding, as multiples are also a factor and are more likely to be a headwind than a tailwind given high current valuations. Multiple moves dominate in the short run, as seen on the way down in 2022 and on the way back up since then. Both our flagship strategy and the index are at high multiples versus history, though the combination of superior cash conversion and our focus on both valuation and quality means that the strategy is only at a circa 10% premium versus the index on a free cash flow basis, which seems too little, given the large quality differential.[5]

The good news is that where a portfolio compounds, it is the compounding that dominates over the longer term. For example, in the event of a 20% de-rating, for a portfolio compounding at 10%, the portfolio's multiple would fall to around 20x forward earnings and a 5% free cash flow yield, reducing the 5-year return to 6% per year while the 10-year return would still be a very respectable 8% per year. By contrast, the index faces a double threat; it's at least as vulnerable on multiples and more vulnerable on earnings. Being "double fussy", on both quality and valuation, seems to us to be the best approach to dealing with the double threat. After all, after the MSCI World has returned 25% in five months and 50% in the last year and a half, keeping the lights on should be more of a priority than shooting them out.[6]

[4] FactSet, April 2024.

[5] Morgan Stanley Investment Management and FactSet, April 2024.

[6] FactSet, April 2024.

DEFINITIONS

A **basis point** is a unit of measure, equal to one hundredth of a percentage point, used in finance to describe the percentage change in the value or rate of a financial instrument.

Dividend yield is the ratio between how much a company pays out in dividends each year relative to its share price.

Earnings per share is the portion of a company's profit allocated to each outstanding share of common stock.

Free cash flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. FCF represents the cash that a company is able generate after laying out the money required to maintain or expand its asset base.

Free cash flow yield is a financial ratio that measures a company's operating free cash flow minus its capital expenditures per share and dividing by its price per share. Free cash flow yield ratio is calculated by using the underlying securities of the fund.

Market Capitalization is the total dollar market value of all of a company's outstanding shares.

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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