COMMENTARY
March 2023

KARPUS INVESTMENT MANAGEMENT

International Equities: A perspective on valuations

A company's price to earnings ratio (PE ratio) is a valuation metric that measures the unit price of a company's earnings. It is a metric not only used for individual equities, but to gauge the valuation levels of indices and can provide insights into market perceptions regarding global equity markets.

For instance, as of March 8, 2023, the iShares Brazil exchange traded fund (EWZ) had a PE ratio of 5.7 and the iShares MSCI India exchange traded fund (INDA) had a PE ratio of 24.1 (and seeks to track the MSCI India Index). Deciding whether to pay $5.70 for $1 of Brazilian earnings focused on steel and oil or $24.10 for a more balanced and future-focused $1 of Indian earnings can be difficult.

All things being equal, one could expect industries with a higher future growth potential to cost more. At 76% off, Brazilian earnings might seem like a bargain barring any other considerations. However, it is our belief that after a more in-depth analysis regarding geography, government, demography, efficiency, and strategic partnership (among others), distinct nuances would become evident showing stark differences between these large emerging nations and explain some of the differences seen by market participants. Essentially, the market assigns a going rate for every dollar of earnings based on merit, mood, and perception. This is illustrated below as we analyze how some U.S. companies generally factor into the world's valuation equation regarding earnings.

In using the most recent data available[1], Apple earned 57% of its revenue outside of the U.S. The same can also be true in reverse though. For instance, Toyota earned less than 21% of its revenue in Japan, Samsung sold an even smaller share in South Korea, and ASML delivered 99.9% of semiconductor manufacturing gear beyond the Netherlands. As shown above, with multiple foreign profit opportunities and consumer bases to explore, we think that the PE ratio is a good place to start to understand how beneficial cross-border investment can be.

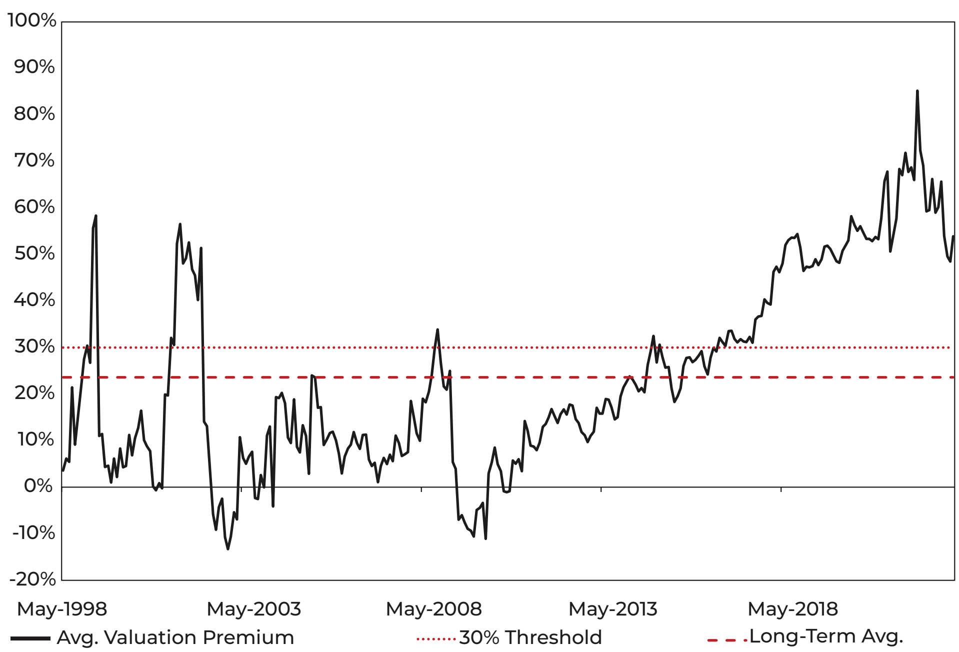
Instead of relying on a single, bottom-line metric, we think a different way to look at valuations paints the picture with broader strokes. To do this, we'll blend in two other valuation metrics: the price/sales ratio and the enterprise value/earnings before interest and taxes ratio. The former ratio covers the top line of the income statement (i.e., a company's revenue or sales before deducting operating costs), while the latter incorporates both a company's debt and a third "mid-table" income statement line.

Based on the average of the three (PE, price/sales, and enterprise value/earnings before interest and taxes ratios), the maximum length of available data tells us that sellers of U.S. equities demand a premium of 25% (please see Chart 1). For purposes of this commentary, we'll call this difference in metric between the Russell 3000 Index and MSCI All Country World ex-US Index, the Stateside Valuation Premium (SVP). One of the reasons that this makes sense is because the U.S. Dollar is the reserve currency of the World. On top of this, we believe the U.S. also has a well-known rule of law and global military capabilities.

What's interesting is that the SVP has grown in the face of pandemic, war, and global inflationary pressures. Days after Russia invaded Ukraine, using the blend of U.S. company metrics above traded at an 85% premium, an all-time high. This analysis demonstrates this margin of safety allows for less desired international companies to under-promise and over-deliver when the safety and security of the U.S. become in demand. Going forward, it is important to keep in mind that past performance is not indicative to future results. In the past, if the monthly SVP registered above 30%, international equities had outperformed in four of the six occurrences, and by an average of 3.6% in the following 12 months.

Using the same data, we can look at another angle (please see Chart 2, on the following page). The difference between the SVP and its one-year trailing moving average (or the SVP Moving Average Differential) shows that when the SVP Moving Average Differential reaches 13% (the Upper Threshold), internationals have outperformed an average of 8.2% the following 12 months and delivered alpha 100% of the time. Additionally, all 8 instances come from different years as this accounts only for initial triggers.

Chart 1. Stateside Valuation Premium



Source: Bloomberg Finance, L.P. Analysis: Karpus Investment Management (5/29/1998 - 2/28/2023)

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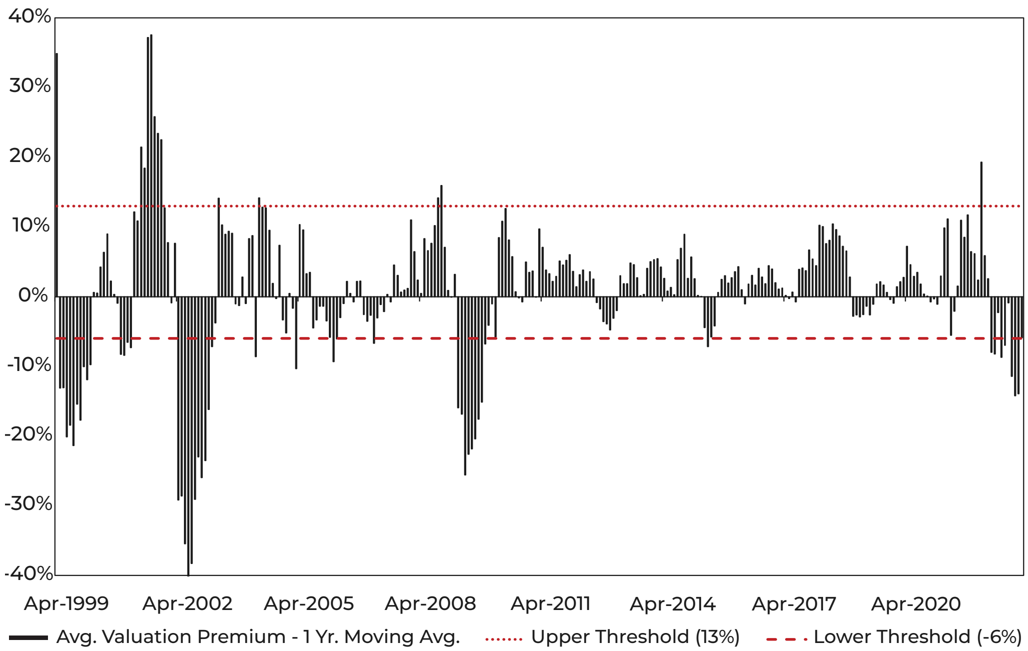
When using rolling dates, the results returned an average of 8.3% outperformance with positive outcomes for 13 out of 13 triggers. To be sure, the spirit of this holds true for any value over 13%, when using this analysis, but this is a more common point of occurrence.

Looking at what's happened when the SVP Moving Average Differential is at the 2/28/23 level of -5.9%, when the ratio is less than -6% (the Lower Threshold), international equities have outperformed U.S. stocks 67% of the time with an average outperformance of 4.6%. This was last triggered 5/31/22, so forward 1-year returns are not yet available, though internationals are outperforming by 0.55% as of the first 9 months of the period. These outcomes stand out when looking at the entirety of the dataset where international equities only come out on top for 38% of all periods.

Chart 2: SVP Moving Average Differential



Source: Bloomberg Finance, L.P. Analysis: Karpus Investment Management (4/30/1999 - 2/28/2023)

In sum, when using this analysis, the MSCI All Country World ex-US Index has outperformed the Russell 3000 Index when the SVP Moving Average Differential breaches the bounds stated above. This means, using these parameters, that the premium that investors pay for U.S. companies over international companies (compared to their average) has implications, regardless of the direction.

Market movement is anything but obvious and today is no different. What we see through the SVP is that U.S. companies have been on a trend of relative richness versus international companies on the heels of a decade of easy money policy. With an inverted yield curve and the U.S. Federal Reserve raising rates post a bank failures, uncertainty is heightened. While we understand that entry points are never exact, perhaps now is a prudent time to consider diversifying into international closed-end funds which we believe offer exposure to foreign businesses, at times when we view they are below the value available in the open market.

For other Karpus Insights, please see our website.

1. Bloomberg Finance, L.P. Apple (AAPL) as of 9/24/22, Toyota (TM) as of 3/31/22, Samsung (005930) as of 12/31/22, ASML as of 12/31/22.

Sources: Bloomberg Finance, L.P., Congressional Research Service

Index Definitions: The Russell 3000 Index is a market-capitalization-weighted equity index that provides exposure to the entire U.S. stock market. The Index tracks the performance of the 3,000 largest U.S. traded stocks which represents approximately 96% of all U.S. incorporated equity securities. The MSCI All-Country World ex. U.S. Index is a market-capitalization-weighted equity index that captures large and mid cap representation across 22 of 23 developed market countries (excluding the United States) and 24 emerging market countries. The Index return is net of withholding taxes and assumes daily reinvestment of net dividends thus accounting for any applicable dividend taxation. Each Index is unmanaged and cannot be purchased directly by investors. The above description of each index is as of 12/31/2022. Data provided by Bloomberg Finance, L.P.

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