WIDENING THE LENS: REVISITING THE CASE FOR NON-U.S. STOCKS

After more than a decade of outperformance, U.S. stocks have come to dominate many equity portfolios, as enthusiasm for artificial intelligence propelled Magnificent 7 tech stocks higher and U.S. growth outpaced peers.

But outside the spotlight, a select group of non-U.S. equities has quietly – but decidedly – made a case for itself. Each year for the past decade, an average of 82 of the top-100 performing stocks in the MSCI All Country World Index were headquartered outside the U.S., their gains driven by strong business models and secular tailwinds that mattered more than their physical address.[1] For investors wary of allocating away from the U.S., these stocks suggest a selective approach to non-U.S. markets could pay off, especially given gaps in valuation between U.S. and non-U.S peers and an equity cycle that is showing signs it could be due for a change.

Key Takeaways:

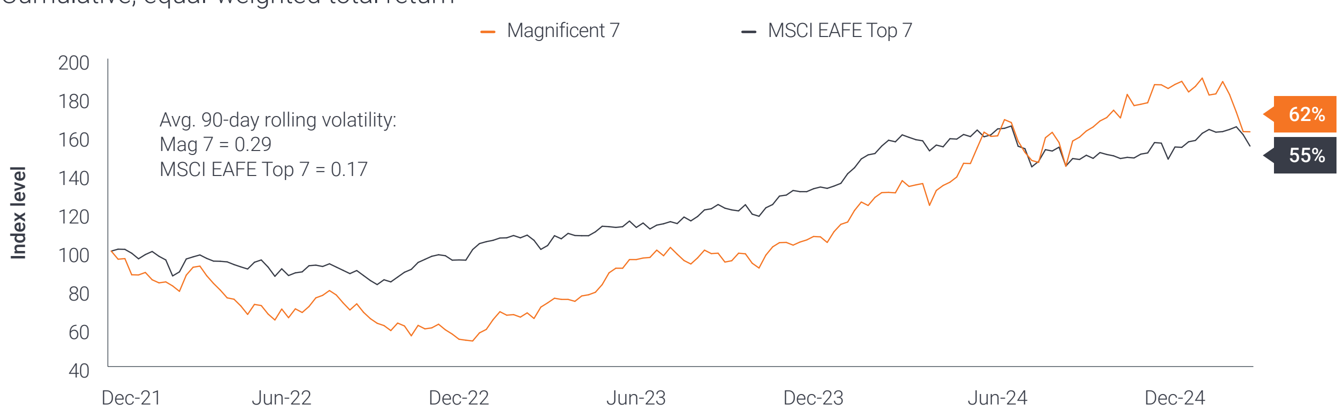
- Though non-U.S. equity benchmarks have trailed the S&P 500 Index for more than a decade, a number of stocks outside the U.S. have delivered some of the best gains during that period.
- Even so, many of these equities trade at a relative discount as investor enthusiasm pushed the S&P 500 to new highs.
- In our view, the valuation gap creates room for upside and an opportunity to diversify equity holdings at a time when history suggests investors should consider looking more globally.

Pockets of comparable performance

The Mag 7's outperformance in the S&P 500 Index is widely recognized. Less known is that, in some cases, top contributors in non-U.S. indices have also achieved robust gains. In fact, while the Mag 7 returned a cumulative 62% since early 2022 on an equal-weighted basis, the top seven contributors in the MSCI EAFE Index delivered 55%, benefiting in part from less volatility, such as during the broad market pullback in 2022, and lower valuations.

Exhibit 1: Top non-U.S. stocks have benefited from strong fundamentals and lower volatility

Cumulative, equal-weighted total return



Source: Bloomberg. Data from 31 December 2021 to 14 March 2025. MSCI EAFE Top 7 = Novo Nordisk, ASML, SAP, Toyota Motor Corp., HSBC, Siemens, and UBS. The MSCI EAFE Index is designed to represent the performance of large- and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada. 90-day rolling volatility is a statistical measure that quantifies the degree of price fluctuations over 90 days. **Past performance cannot guarantee future results.**

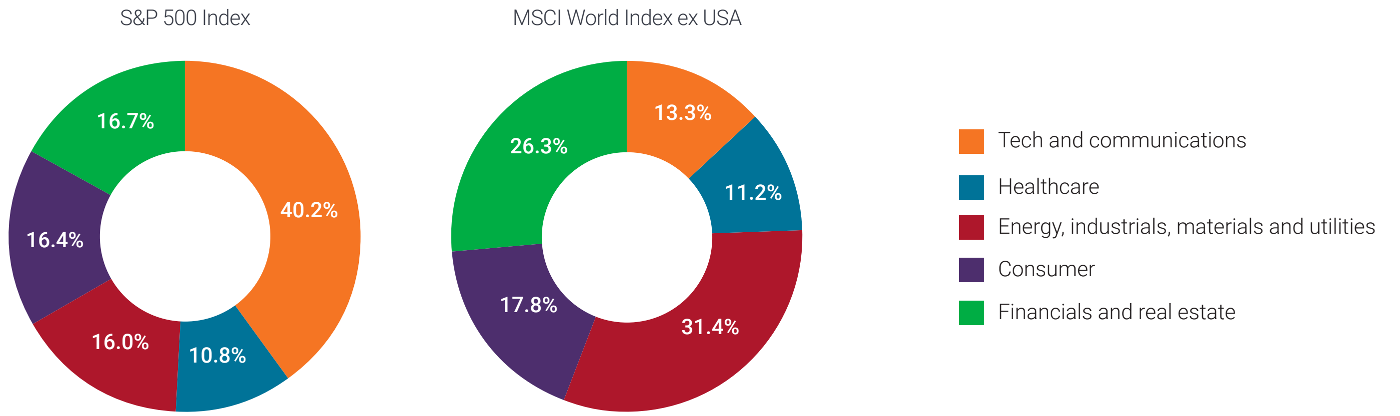
[1] Morningstar, as of 31 December 2024.

Diversified sources of return

Notably, the leading stocks in the MSCI EAFE were not all tech names. Rather, the group consisted of healthcare, industrials, and financials (as well as tech). This lack of sector concentration provided investors with portfolio diversification and reflected growth drivers besides AI, including rising defense spending, rapid medical innovation, and the end of zero-rate monetary policies.

Exhibit 2: Sector diversification outside of the U.S.

Technology makes up a smaller portion of non-U.S. markets, providing exposure to other sectors



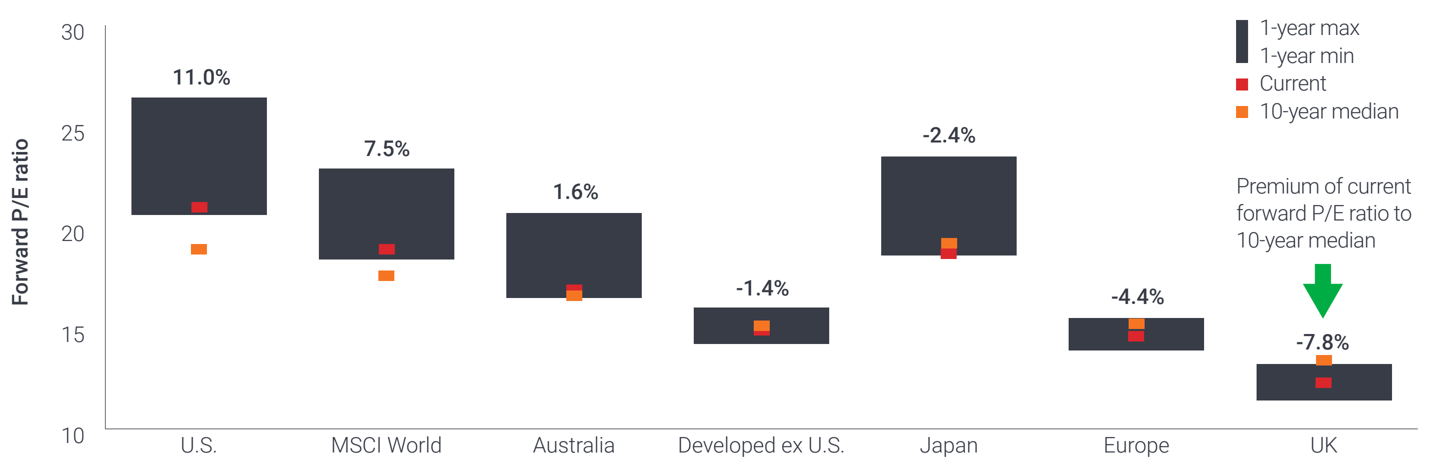
Source: S&P Global, MSCI. As of 28 February 2025. The MSCI World Index ex USA Index captures large- and mid-cap representation across 22 of 23 developed markets countries (excluding the U.S.).

A valuation advantage

Even with recent gains, many top-performing non-U.S. stocks trade at a discount to U.S. peers. Some valuation gap may be warranted given faster economic growth in the U.S. and the potential earnings and productivity advantages of AI. But the premium/discount appears to reflect a market that prioritizes geography over fundamentals, even those that are positive. In the MSCI Europe Index, for example, roughly three-quarters of sales are now generated outside the Eurozone, similar to the S&P 500 Technology sector, which does nearly 60% of revenues in non-U.S. markets.[2]

Exhibit 3: U.S. stocks carry multiples well above foreign peers

U.S. stocks trade at a premium to their 10-year median, as well as to non.-U.S. developed markets



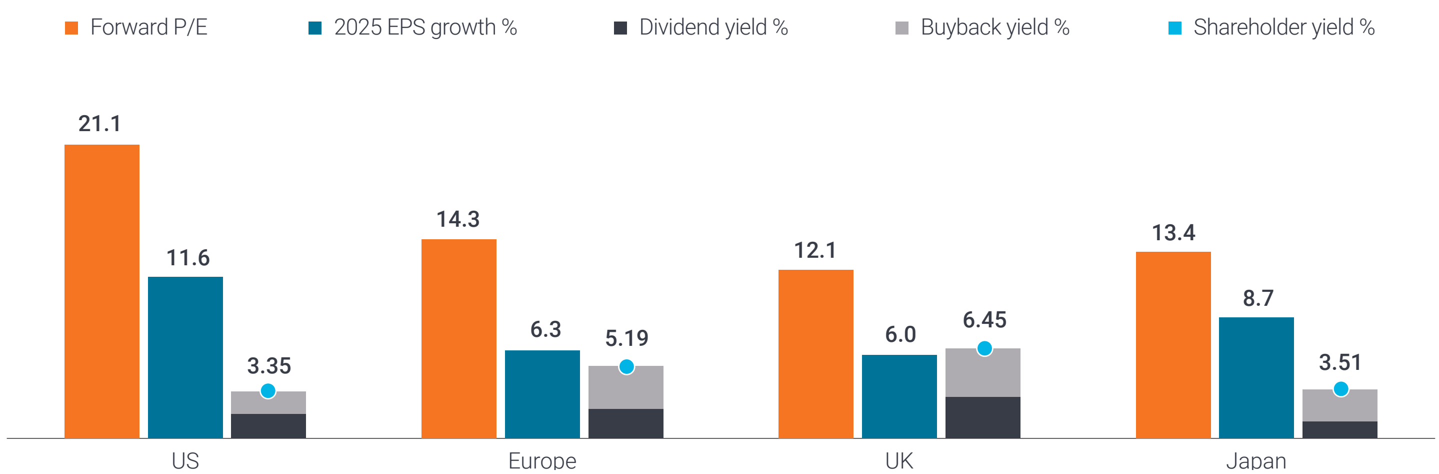
Source: Bloomberg, as of 14 March 2025. P/Es based on forward 12-month estimated earnings. US=S&P 500 Index. Australia=S&P/ASX 200 Index, a market-capitalization weighted and float-adjusted index of stocks listed on the Australian Securities Exchange. Developed ex U.S.=MSCI EAFE Index. Japan=Nikkei 225 Index, which consists of Japan's top 225 companies traded on the Tokyo Stock Exchange. Europe=STOXX 600 Europe Index, which represents large, mid and small capitalization companies across 17 countries of the European region. UK=FSTE 100 Index, an index of the 100 most highly capitalized blue chip stocks listed on the London Stock Exchange.

[2] FactSet, as of 31 December 2024. The S&P 500 Technology Sector comprises those companies included in the S&P 500 that are classified as members of the GICS® information technology sector.

Attractive shareholder yield

This geographic handicap leaves room for upside, in our view, among high-performing non-U.S. companies. There's also opportunity for capital payouts, with shareholder yield – a measure of dividends and buybacks – typically more generous outside the U.S. Even in Japan, where corporate governance standards have lagged for years, new reforms are pressuring public firms to unlock more value for investors. In 2024, share buybacks in Japan hit a record high of more than ¥18 trillion (USD $121 billion), up from less than ¥10 trillion in 2023. For 2025, the sum is expected to top ¥20 trillion.[3]

Exhibit 4: Non-U.S. equities have returned more capital to shareholders



Source: As of 14 March 2025. Forward P/E based on 12-month estimated earnings and 2025 projected EPS Growth from LSEG Datastream IBES estimates. Dividend yield from FactSet. US = S&P 500 Index. Europe/UK = MSCI indices. Japan = TOPIX. Dividend yield is a financial ratio that shows how much a company pays out in dividends each year relative to its stock price. Buyback yield reflects the percentage of a company's market capitalization returned to common shareholders in the form of stock buybacks. Shareholder yield is the sum of a stock's dividend yield and the percentage of net share buybacks over the previous twelve months.

A history of mean reversion

To be sure, non-U.S. markets have faced challenges. In 2024, Germany, the engine of the Eurozone economy, had its second straight year of recession, while cumbersome regulations have raised costs and stifled demand across Europe. Meanwhile, Japan only recently emerged from a prolonged period of deflation and still has a ways to go with corporate reforms. (Nearly half of companies in the Tokyo Stock Price Index still trade below book value compared to less than 4% of U.S. companies.)[4]

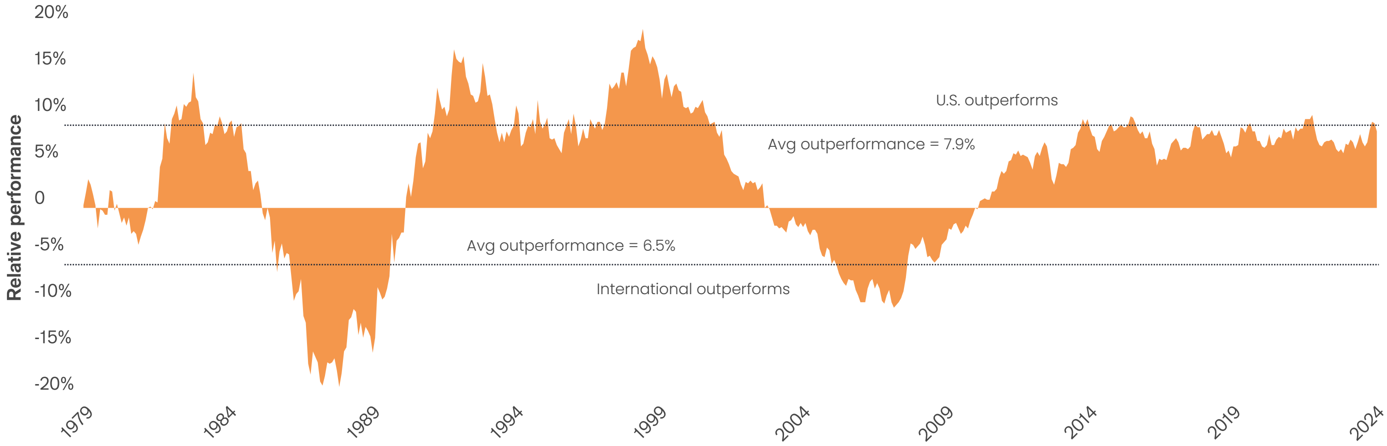
But history shows global equity returns tend to be cyclical and that outperformance can flip, often after periods of stretched valuations. Since 1980, U.S. and non-U.S. stocks have consistently taken turns leading markets, with the most enduring U.S.-led periods lasting an average of more than eight years. Should markets keep up the pattern, non-U.S. equities could soon have their comeuppance: U.S. stocks' current run on top has lasted roughly 14 years.

[3] Ichiyoshi Securities, The Japan Times, as of 31 December 2024. "Listed Japanese firms' share buybacks hit record in 2024."

[4] Bloomberg, as of 28 February 2025.

Exhibit 5: U.S./non-U.S. stocks have alternated outperformance

S&P 500 vs. MSCI EAFE five-year monthly rolling returns



Source: Bloomberg. Data from 31 December 1979 to 28 February 2025. U.S.=S&P 500 Index. Non-U.S.=MSCI EAFE Index. **Past performance cannot guarantee future results.**

Not timing the cycle

While it is impossible to pinpoint if or when a rotation might occur, an active approach to non-U.S. stocks could still pay dividends in a diversified portfolio. Over the past decade, 65% of actively managed international funds have outperformed their respective benchmarks on an annualized basis.[5] Meanwhile, structural changes that have started to take hold – from a faster pace of rate cuts and pledges to increase defense spending in Europe to market reforms in Japan – create the potential for differentiated returns (see Case example).

Avoiding recency bias

In the end, staying focused on fundamentals could also help investors avoid recency bias, or the tendency to extrapolate recent data points into perpetuity. In fact, historically, allowing recency bias to determine investment decisions would have meant overweighting international stocks in 1990, U.S. stocks in 2000, and international stocks in 2008 – all times when the opposite would have been the better choice.

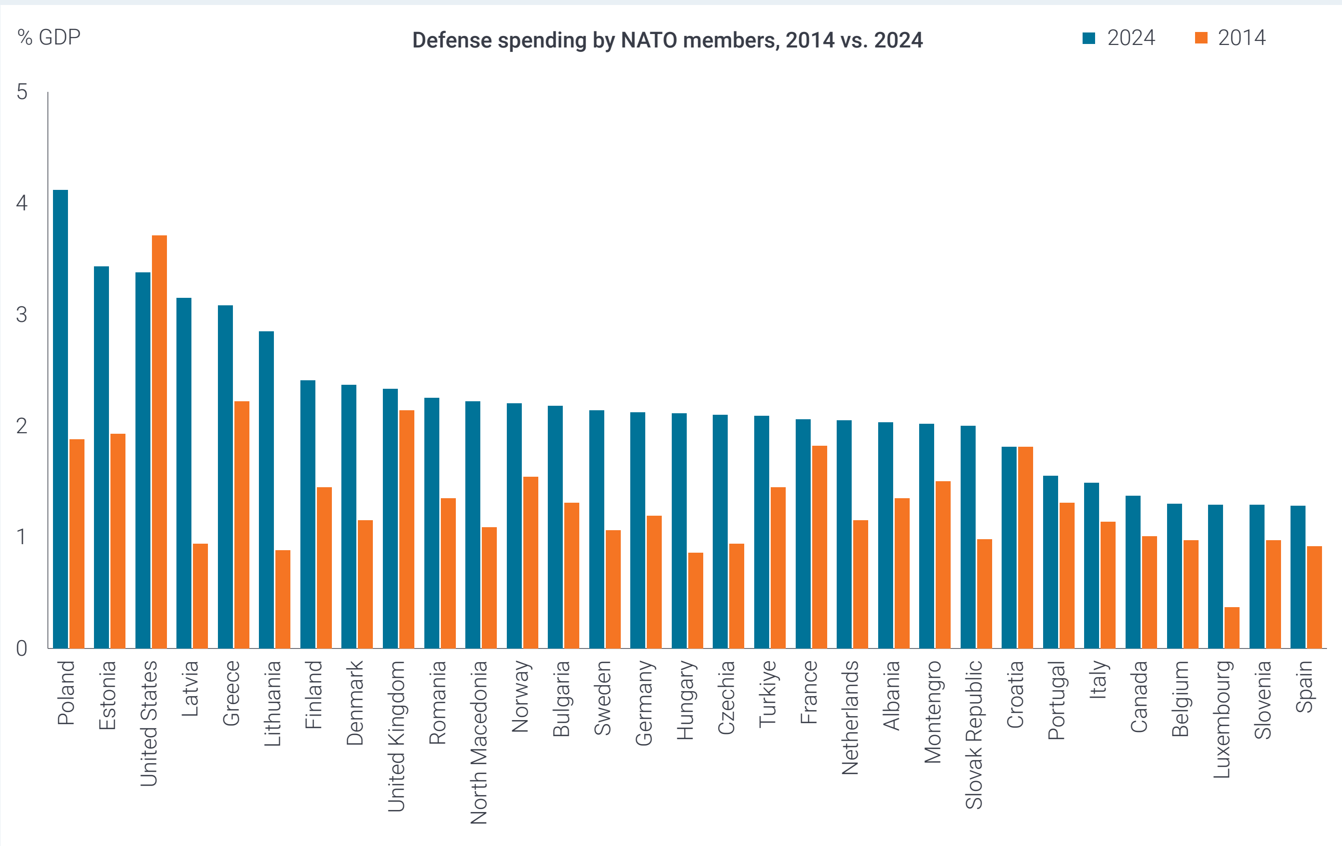
[5] Morningstar. Data are for 10-year annualized returns for active foreign large-blend funds versus their benchmarks from 1 January 2015 to 31 December 2024.

Case example: European defense

Following the Cold War, defense budgets in Europe experienced little to no growth. But amid new geopolitical tensions and a change in White House leadership, defense spending in the region looks set to accelerate.

Already, countries located near Russia have been dramatically increasing defense expenditures as a percentage of their gross domestic product (GDP). Poland, for example, committed more than 4% of its GDP in 2024, up from less than 2% a decade ago. More recently, Ursula von der Leyen, president of the European Commission, said the EU plans to activate a mechanism that allows member states to substantially increase defense expenditures without having to make cuts elsewhere. She also proposed lending up to 150 billion euros (US$158 billion) to EU governments to rearm amid worries about faltering U.S. support for Ukraine. Some countries have already taken action. Germany's incoming government, for example, recently voted to launch a 500 billion euro ($540 billion) fund to invest in infrastructure projects and amend the constitution to exclude defense outlays from fiscal spending limits.

The shift in policy has helped to lift non-U.S. defense stocks, but with shares having traded at discounted valuations for several years, markets may now only be starting to catch up to the potential for faster growth.



Source: NATO, Defence Expenditure of NATO Countries (2014-2024), 17 June 2024. GDP=gross domestic product. NATO=The North Atlantic Treaty Organization, an intergovernmental transnational military alliance of 32 member states (30 European and two North American). Data excludes Iceland, which has no armed forces.

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Price-to-Earnings (P/E) Ratio measures share price compared to earnings per share for a stock or stocks in a portfolio.

Volatility measures risk using the dispersion of returns for a given investment.

Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

Foreign securities are subject to additional risks including currency fluctuations, political and economic uncertainty, increased volatility, lower liquidity and differing financial and information reporting standards, all of which are magnified in emerging markets.

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