

A new age of discovery: the case for international equities

[May 2025]

As with any investment, your capital is at risk. Past performance is not a guide to future returns.

Andrew Brown (AB): Bea, it feels like the tide is turning for international equities. Performance is beginning to improve. A number of our clients are appraising their allocations. You've written a paper on this topic. You start with a really interesting analogy. You talk about Christopher Columbus and the age of discovery. Can you elaborate on that?

Beatrice Faleri (BF): Yeah. There is a sentence that I kept hearing over and over again in the last few months in the news. And the sentence is, we live in an uncharted world. And that describes the sense that the coordinates, economic, technological, geopolitical coordinates that we're used to are shifting. And if you think about it, that makes sense, because since the early 2020s, we've had a global pandemic, shifts in interest rates, rewiring of the world supply chains, and now geopolitical and trade tensions. It really feels like we don't know where we're going. The world is not as it used to be.

But that sentence cast my mind back to the time where the world was actually uncharted, and that was in the 15th and 16th century, when Columbus first set foot on American soil, and suddenly that started a wave of European exploration towards the unknown. And the explorers of the time believed that by going to the edges of the map, they might yet find incredible opportunities and incredible riches. And it kind of feels like that in equity markets today, except the geography is flipped.

So you have the US, which is this well-trodden, well-known market, and then you're looking out to what used to be the old world of emerging markets, developed Asia, Europe, that looks unmapped, undiscovered, but it's full of opportunities.

(AB): And you talk about the map of global markets being distorted by what's happening in the US. What's this distortion?

(BF): Well, the symptom of the distortion that you can see in the US market is, first of all, about concentration levels. So as recently as last year, 40 per cent of the S&P 500 was made up of just 10 companies. That's a level of concentration that we hadn't seen before. And similarly, valuations were very high compared to international markets, especially the US was trading as almost twice the multiple of their counterparts. And all of this is starting to change now, especially since the beginning of the year with trade tensions and geopolitical tensions. And that's challenging the exceptionalism of the U.S. in our world. But it's still fair to say that for the last few years, being in the U.S. has been what investors have been used to, and looking out, there isn't not that much.

(AB): And so why is this opportunity so compelling from where we are today?

(BF): Well, to me, international markets are compelling for three very obvious reasons. The first one is sheer scale. So if you think about China, that country alone has over 5,000 listed companies. That's a scale that's really incredible compared to any other country in the world. But then if you put it together into an index, the MSCI ACWI ex US has 2,000 companies in it, over 46 countries.

That leads me to my second point, which is diversification. You wouldn't necessarily have that exposure in any single country index. And it's not just about geography or sector or industry, but it is about economic cycles that are happening in different places of the world at the same time. And even more importantly, it's about structural trends that are changing the world at different paces. So if you think about digitalization of emerging markets or the energy transition in Europe.

And the third point, which is also important, is valuation. So emerging markets especially, but international markets in general, have been trading at a discount to their US peers for quite a long time. And sometimes there's kind of an unknown element to it. There is a price, a currency risk. There is a political risk. But what really matters to us when we look at this is sometimes there is very high-quality businesses that are trading at what we see as an unjustified discount to their US peers. And therein lies a great opportunity.

(AB): So one way of gaining exposure to this opportunity is to invest passively, just to invest in an index. But in your paper, you make the case for active management. What is that case?

(BF): Well, investing passively is a bit like using a medieval map, where you have very precise coastlines, but the detail in their interior are very, very hazy. But that interior is where the treasure may lie. And you wouldn't find it using a passive index. So to make it a bit more real, think about MercadoLibre. This is one of the most successful international listed companies in our universe. It has returned many multiples to investors since IPO.

It has completely revolutionized ecommerce and fintech in Latin America, and yet it simply wasn't part of international indexes for years. So passive investors would have completely missed out on the spoils of this discovery. Whereas with an active approach where you have the right lenses, the right tools, and years of experience in exploring international markets, you might stand a chance to find the companies that are going to revolutionise the world before the world catches up.

(AB): So you mentioned lenses there, having the right lenses. What lenses do you view the international opportunity through?

(BF): Yeah, so in the paper I talk about these three ways of looking at international markets that can help us spot these interesting opportunities and these companies that are unique to this universe. The first lens I talk about is persistence. This is about enduring businesses that have enduring owners. The second one is interconnectedness, the hidden plumbing of the digital economy and of innovation. And the third one is serendipity, which is about finding disruption and innovation in places that you wouldn't expect. So these are three ways that we can use to look at international markets.

(AB): Okay, let's take each of these lenses in turn, starting with persistence. What's the essence of that?

(BF): So persistence is about enduring owners creating enduring businesses. That is particularly obvious in luxury, which is very well represented in a European context. Let's take LVMH. This is the biggest luxury conglomerate in the world. Some of the brands that are part of LVMH hail from the 16th and 17th century. And the reason why these companies have survived and thrived for so long has been because the backing of patient capital has created a flywheel that most other listed companies can't replicate, that turned their heritage of craftsmanship into enduring brand and pricing power.

And you can only do that if you have a family like the Arnaud family supporting and relentlessly reinvesting into this brand power and stewarding these brands. You can see this in Hermès and Ferrari, two other famous luxury brands in Europe. But it's not just luxury. You also have companies like Atlas Copco in Sweden that have been backed by the Wallenberg Family Foundation, Investor AB for centuries.

And that has allowed this business the kind of decentralisation and flexibility that has made it one of the most successful industrial companies in Europe, especially because it pivots from industrial niche to industrial niche, chasing growth and not worrying about upsetting its shareholders because it has this patient capital backing it and backing this flexibility.

(AB): Yeah, interesting. It certainly does sound like an area that gives you unique exposure through international equities. And interconnectedness, or as you refer to in the paper, the underground plumbing of innovation.

(BF): Yes, so a very live example of this is semiconductors and what they power. So if you think about the US hyperscaler, they get a lot of attention today, but they wouldn't have got as big as they have, and they certainly wouldn't be able to power large language models without the presence of this underground supply chain that creates and assembles and powers, ultimately, the digital economy.

It's obvious in the semiconductor supply chain. You have ASML that makes lithography machines, TSMC that manufactures chips, even niche players like Technoprobe that tests chips, or Soitec that makes cooling systems for data centres. But then there's other swathes of the digital economy that also run on international rails. Think about omnichannel commerce. Adyen processes payments worldwide, that's a Dutch company. You have Canadian Shopify that allows small businesses to have an online presence. And then there is SAP that creates the digital ecosystem on which many of the largest companies in the world run. These are essential parts of the economy, essential players, enablers of digitalisation, and yet they often go under-discovered because they're not as flashy.

(AB): It's a really interesting reminder, isn't it, of how many critical companies are based outside of the US. And your final lens, I've not heard anyone talk about things this way actually, serendipity. I'd be really keen to hear more about that.

(BF): Yeah, serendipity is about the idea that innovation and disruption happens not because of abundance, but because actually the conditions make it quite hard for innovation to happen, because there are some local constraints, for example. So I was reading about the founding of Spotify, and I found out that music piracy was rife in Sweden in the early 2000s. And Daniel Ek tried to find a way to make consuming music and music streaming as convenient as pirating it, but legal. And that's how Spotify was born, and it's completely changed the way we consume and pay for content.

But then you find other examples of serendipitous businesses in emerging markets as well. So MercadoLibre, which I was talking about earlier, it has become the absolute leader in ecommerce and fintech in Latin America. And that was an area that before MercadoLibre didn't have the infrastructure that you'd expect for a digital business to emerge. People didn't have bank accounts, people didn't even have physical addresses. And so MercadoLibre had to invest very heavily in this kind of physical infrastructure in order to create the ecosystem that it has. But that has made sure that now its dominance can hardly be questioned or challenged by new entrants.

And on the other hand, you have Asian markets where ecommerce is very highly penetrated, where competition made it so that players like SEA had to change the way you do ecommerce. And to maintain engagement, they had to gamify ecommerce and completely change that business model. So local constraints are kind of springboards for local entrepreneurs to change business models and create innovation that way in emerging markets and in international markets in general.

(AB): Well, Bea, we've covered a lot of ground. We've used a very interesting analogy to talk about the case for international, why it works for active management, and what the lenses are that you view. What are the key messages that you really want to leave from this paper?

(BF): Well, the overarching message is international markets are more exciting than ever. And that's not just because of valuations, not just because of concentration level, not just because of diversification, but it is also about finding these extraordinary businesses, businesses that enable the digital economy, businesses that endure for generations, businesses that create innovation where you least expect. And with the right lenses, you can find this business and you may be able to find those extraordinary companies that will drive returns for the next decade. This is why I think we are at the start of a new age of discovery for international markets.

(AB): Well, that's a great point to finish on. Thank you very much, Bea, for your time today.

(BF): Thank you.

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