

# All we are saying is give EAFE a chance

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | 2021

The U.S. market (MSCI U.S. Index) crushed EAFE again in 2020, gaining 21% versus the MSCI EAFE Index's +8%, even if the fourth quarter (Q4) saw a rare marginal win for EAFE, which rose 16% versus the U.S. gain of 13%. This extended the last decade's rampant outperformance by the U.S., which has delivered 252% since 2010 (13.4% per year), while EAFE only managed 71%, or 5.6% per year.

Valuation has contributed to the U.S. outperformance, as the multiple of next 12 months' earnings has expanded from 13.3x to 23.5x, while EAFE trails on a "mere" 17.5x. That said, the main driver has been sharply better earnings performance, with forward earnings up 73% for the U.S., but actually down 13% for EAFE over the 10-year period.

The stretched U.S. valuation might give EAFE a chance to outperform, but what is really required is for EAFE to "out-earn" the U.S., in contrast to the experience of the 2010s. While we would not be nearly brave enough to make this a definitive forecast, there are some reasons to believe it may be possible. Until the middle of last year, the strengthening dollar had been a relative tailwind for U.S. earnings, as revenues earned outside the U.S. were worth a falling amount of dollars. But if the second half 2020 dollar weakness continues, this process will go into reverse.

More broadly, the U.S. may not sustain the faster economic growth it managed over the last decade. The International Monetary Fund forecasts average annual gross domestic product growth of 2.8% for Europe over the next five years, versus 2.4% for the U.S., helped by a steeper recovery in 2021 given the deeper European trough in 2020. If accurate, this would contrast with the 2010-19 period, where the

AUTHOR



**BRUNO PAULSON**  
*Managing Director*

"There are reasons to believe it may be possible for EAFE to "out-earn" the U.S."



U.S. outgrew Europe, with the U.S. having grown 2.3% while Europe grew 1.7%. In addition, EAFE's sector mix may benefit more from the post-COVID-19 recovery. Using hard cyclicals (industrials, materials and energy) plus financials as a proxy for cyclicality, EAFE is far more exposed to the macro cycle, with 43% of the index in these sectors, versus only 24% in the U.S.

U.S. profits were helped over the last few years by the Trump tax cuts, as well as broader business-friendly policies, not least around anti-trust, in contrast to the more environment, consumer and labour-focused policies in Europe. It is not yet clear how much of a challenge the Biden administration will offer to corporate profits, but it is likely to cleave closer to the European model. More broadly, U.S. governance has been seen as vastly superior to that of the European Union (EU). Given the successful passing of the EU's €750 billion recovery plan supported by jointly issued debt, and the less-than-optimal current functioning of the U.S. polity, it is rather less clear that this advantage remains.

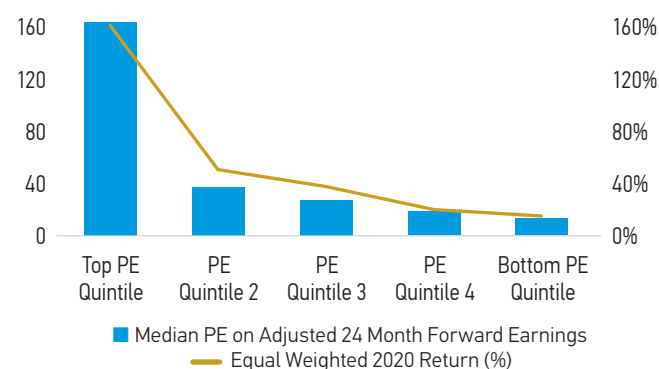
**"Dependence on a few large companies is a potential source of growth for the U.S. market, but also a potential source of vulnerability."**

One extra U.S. edge since the Global Financial Crisis has been the far higher technology weight, with information technology now 28% of the MSCI U.S. Index, versus only 9% in the MSCI EAFE Index, even before counting "pseudo-tech" companies in e-commerce, streaming, electric vehicles, and social media, which add another 11% to the U.S. exposure. This has been a major engine of performance, returning 533% over the decade. Indeed, the information technology sector alone delivered 62% of the MSCI U.S. Index's 21% 2020 return, while adding in five pseudo-tech companies (regarded by most people, if not MSCI, as technology companies) takes this share to 96%, meaning that the rest of the U.S. market only delivered 4% of the index performance. Another way of looking at it is that over half of the total MSCI World Index performance in 2020 was delivered by five U.S. companies, and 78% by the top 25 companies in the index, of which only one is listed outside the U.S. This dependence on a few large companies, mainly in the tech area, is a potential source of continued growth for the U.S. market, but also a potential source of vulnerability. Unlike in the 1999 tech bubble, these are real companies generating massive earnings with significant runways for growth, but there are significant regulatory threats across the globe, around anti-trust, publishing rules and privacy. Any significant threat to their earnings power could have a severe effect on overall U.S. market returns.

**"The euphoria in the growthier end of the market can be seen in the MSCI World Index's information technology returns."**

The other technology issue is at the more speculative end of the market. 2020 saw a spectacular 480 initial public offerings, amongst which there were 248 SPACs (special purpose acquisition companies), also known as "shell" or "blank cheque" companies. The euphoria in the growthier end of the market can be seen in the MSCI World Index's information technology returns. Splitting the sector into five quintiles by adjusted 24-month forward earnings shows, as in the chart below, the seeming exuberance. The top quintile has a median price-to-earnings ratio (P/E) of 166 times adjusted earnings. This P/E is arguably generous, as using pure GAAP/IFRS numbers, i.e., deducting share-based compensation, takes the majority of this quintile into loss, even two years forward. This elevated valuation was helped by the group's average 2020 return of 163%. Even the relatively sober second quintile has adjusted P/Es from 33 times to 56 times, and saw a return of over 50%. Any deflation here could crimp the U.S. market as well, while EAFE would be far less affected.

**DISPLAY 1**  
**2020 Return by Information Technology Valuation Quintiles**



Source: FactSet and Morgan Stanley Investment Management

There are only two ways of losing money in equities: either earnings have to go away or the multiples have to go away. We would argue that the U.S. is at higher risk of both compared to EAFE, given fairly elevated earnings and multiples, even outside technology. The dowdy EAFE markets look less glamorous but less risky, particularly given the potential revival of Europe. Indeed, a 17.5x multiple for MSCI EAFE certainly looks less frightening than a 24x valuation. Now more than ever, it is time to focus on keeping the lights on, rather than attempting to shoot them out, and a quality-biased portfolio in less fashionable markets does seem a reasonable way of limiting the risk of a plunge into darkness.

## Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect **global franchise companies** and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. **Stocks of small-capitalisation companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility.

## DEFINITIONS

**Earnings before interest, taxes, and amortization (EBITA)** is a measure of company profitability used by investors. It is helpful for comparison of one company to another in the same line of business. **Generally accepted accounting principles, or GAAP**, are a set of rules that encompass the details, complexities, and legalities of business and corporate accounting. **International Financial Reporting Standards (IFRS)** are accounting standards that are issued by the International Accounting Standards Board (IASB) with the objective of providing a common accounting language to increase transparency in the presentation of financial information. **Net Debt to EBITDA** is a debt ratio calculation that can be used as a measurement of leverage, which shows how many years it would take for a company to pay back its current debt if net debt and EBITDA are held constant. **Price/earnings (P/E)** is the price of a stock divided by its earnings per share. Sometimes called the multiple, P/E gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and therefore the more earnings growth they are expecting.

## INDEX DEFINITIONS

The indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index. Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto. The **MSCI EAFE Index** (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the international equity market performance of developed markets, excluding the US & Canada. 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 MSCI EAFE Index currently consists of 21 developed market country indices. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends. The **MSCI U.S. Index** is designed to measure the performance of the large and mid cap segments of the U.S. market. 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.

## DISTRIBUTION

**This communication is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.**

**Ireland:** MSIM Fund Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland. Registered in Ireland as a private company limited by shares under company number 616661. MSIM Fund Management (Ireland) Limited is regulated by the Central Bank of Ireland. **United Kingdom:** Morgan Stanley Investment

Management Limited is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA, authorised and regulated by the Financial Conduct Authority. **Dubai:** Morgan Stanley Investment Management Limited (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158). **Germany:** MSIM Fund Management (Ireland) Limited Niederlassung Deutschland, Grosse Gallusstrasse 18, 60312 Frankfurt am Main, Germany (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Italy:** MSIM Fund Management (Ireland) Limited, Milan Branch (Sede Secondaria di Milano) is a branch of MSIM Fund Management (Ireland) Limited, a company registered in Ireland, regulated by the Central Bank of Ireland and whose registered office is at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland. MSIM Fund Management (Ireland) Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy, is registered in Italy with company number and VAT number 11488280964. **The Netherlands:** MSIM Fund Management (Ireland) Limited, Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch office of MSIM Fund Management (Ireland) Limited. MSIM Fund Management (Ireland) Limited is regulated by the Central Bank of Ireland. **France:** MSIM Fund Management (Ireland) Limited, Paris Branch is a branch of MSIM Fund Management (Ireland) Limited, a company registered in Ireland, regulated by the Central Bank of Ireland and whose registered office is at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland. MSIM Fund Management (Ireland) Limited Paris Branch with seat at 61 rue de Monceau 75008 Paris, France, is registered in France with company number 890 071 863 RCS. **Spain:** MSIM Fund Management (Ireland) Limited, Sucursal en España is a branch of MSIM Fund Management (Ireland) Limited, a company registered in Ireland, regulated by the Central Bank of Ireland and whose registered office is at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland. MSIM Fund Management (Ireland) Limited, Sucursal en España with seat in Calle Serrano 55, 28006, Madrid, Spain, is registered in Spain with tax identification number W0058820B. **Switzerland:** Morgan Stanley & Co. International plc, London, Zurich Branch Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-115.415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile Fax: +41(0) 44 588 1074.

## U.S.

A separately managed account may not be appropriate for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required. For important information about the investment manager, please refer to Form ADV Part 2.



**Please consider the investment objectives, risks, charges and expenses of the funds carefully before investing. The prospectuses contain this and other information about the funds. To obtain a prospectus please download one at [morganstanley.com/im](http://morganstanley.com/im) or call 1-800-548-7786. Please read the prospectus carefully before investing.**

Morgan Stanley Distribution, Inc. serves as the distributor for Morgan Stanley funds.

**NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT**

**Hong Kong:** This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This document should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"); (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. This publication has not been reviewed by the Monetary Authority of Singapore. **Australia:** This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accept responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

**BRAZIL.** This document does not constitute a public offering of securities for the purposes of the applicable Brazilian regulations and has therefore not been and will not be registered with the Brazilian Securities Commission (Comissão de Valores Mobiliários) or any other government authority in Brazil. All information contained herein is confidential and is for the exclusive use and review of the intended addressee of this document, and may not be passed on to any third party.

**CHILE.** Neither the Fund nor the interests in the Fund are registered in the Registry of Offshore Securities (el Registro de Valores Extranjeros) or subject to the supervision of the Commission for the Financial Market (la Comisión para el Mercado Financiero). This document and other offering materials relating to the offer of the interests in the Fund do not constitute a public offer of, or an invitation to subscribe for or purchase, the Fund interests in the Republic of Chile, other than to individually identified purchasers pursuant to a private offering within the meaning of Article 4 of the Chilean Securities Act (la Ley del Mercado de Valores) (an offer that is not "addressed to the public at large or to a certain sector or specific group of the public").

**COLOMBIA.** This document does not constitute an invitation to invest or a public offer in the Republic of Colombia and is not governed by Colombian law. The interests in the Fund have not been and will not be registered with the National Register of Securities and Issuers (el Registro Nacional de Valores y Emisores) maintained by the Financial Supervisory Authority of Colombia (la Superintendencia Financiera de Colombia) and will not be listed on the Colombian Stock Exchange (la Bolsa de Valores de Colombia). The interests in the Fund are being offered under circumstances which do not constitute a public offering of securities under applicable Colombian securities laws and regulations. The offer of the interests in the Fund is addressed to fewer than one hundred specifically identified investors. Accordingly, the interests in the Fund may not be marketed, offered, sold or negotiated in Colombia, except under circumstances which do not constitute a public offering of securities under applicable Colombian securities laws and regulations. This document is provided at the request of the addressee for information purposes only and does not constitute a solicitation. The interests in the Fund may not be promoted or marketed in Colombia or to Colombian residents unless such promotion and marketing is carried out in compliance with Decree 2555 of 2010 and other applicable rules and regulations related to the promotion of foreign financial and securities related products or services in Colombia.

Colombian eligible investors acknowledge that the interests in the Fund (i) are not financial products, (ii) are transferable only in accordance with

the terms of the Fund's constitutional documents and (iii) do not offer any principal protection.

Colombian eligible investors acknowledge Colombian laws and regulations (in particular, foreign exchange, securities and tax regulations) applicable to any transaction or investment consummated in connection with an investment in the Fund, and represent that they are the sole liable party for full compliance with any such laws and regulations. In addition, Colombian investors acknowledge and agree that the Fund will not have any responsibility, liability or obligation in connection with any consent, approval, filing, proceeding, authorization or permission required by the investor or any actions taken or to be taken by the investor in connection with the offer, sale or delivery of the interests in the Fund under Colombian law.

**MEXICO.** Any prospective purchaser of the interests in the Fund must be either an institutional investor (inversionista institucional) or a qualified investor (inversionista calificado) within the meaning of the Mexican Securities Market Law (Ley del Mercado de Valores) (the "Securities Market Law") and other applicable Mexican laws in effect.

The interests in the Fund have not and will not be registered in the National Registry of Securities (Registro Nacional de Valores) maintained by the Mexican Banking and Securities Commission (Comisión Nacional Bancaria y de Valores). The interests in the Fund may not be offered or sold in the United Mexican States by any means except in circumstances which constitute a private offering pursuant to Article 8 of the Securities Market Law and its regulations. No Mexican regulatory authority has approved or disapproved the interests in the Fund or passed on the solvency of the Fund. All applicable provisions of the Securities Market Law must be complied with in respect of any sale, offer or distribution of, or intermediation in respect of, the Fund interests in, from or otherwise involving Mexico, and any resale of the interests in the Fund within Mexican territory must be made in a manner that will constitute a private offering pursuant to Article 8 of the Securities Market Law and its regulations.

**PERU.** The interests in the Fund have not been and will not be registered in Peru under Decreto Legislativo 862: Ley de Fondos de Inversión y sus Sociedades Administradoras or under Decreto Legislativo 861: Ley del Mercado de Valores (the "Securities Market Law"), and are being offered to institutional investors only (as defined in article 8 of the Securities Market Law) pursuant to a private placement, according to article 5 of the Securities Market Law. The interests in the Fund have not been registered in the securities market public registry (Registro Público del Mercado de Valores) maintained by, and the offering of the Fund interests in Peru is not subject to the supervision of, the Superintendencia del Mercado de Valores. Any transfers of the Fund interests shall be subject to the limitations contained in the Securities Market Law and the regulations issued thereunder.

**URUGUAY.** The offering of the Interests qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. The Interests will not be offered or sold to the public (Individuals or Companies) in Uruguay, except in circumstances which do not constitute a public offering or distribution through a recognized Exchange under Uruguayan laws and regulations. Neither the Fund nor the Interests are or will be registered with la Superintendencia de Servicios Financieros del Banco Central del Uruguay. The Fund corresponds to an investment fund that is not an investment fund regulated by Uruguayan law 16,774 dated September 27, 1996, as amended.

**Japan:** For professional investors, this document is circulated or distributed for informational purposes only. For those who are not professional investors, this document is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIMJ")'s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.20% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges

also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This document is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

#### IMPORTANT INFORMATION

**EMEA: This marketing communication has been issued by MSIM Fund Management (Ireland) Limited. MSIM Fund Management (Ireland) Limited is regulated by the Central Bank of Ireland. MSIM Fund Management (Ireland) Limited is incorporated in Ireland as a private company limited by shares with company registration number 616661 and has its registered address at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland.**

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy's/product's relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

A separately managed account may not be suitable for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing.

This material is a general communication, which is not impartial and has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular

security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

Except as otherwise indicated herein, the views and opinions expressed herein are those of the portfolio management team, are based on matters as they exist as of the date of preparation and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date hereof.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific Morgan Stanley Investment Management product.

MSIM has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation.

Additionally, financial intermediaries are required to satisfy themselves that the information in this document is suitable for any person to whom they provide this document in view of that person's circumstances and purpose. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without MSIM's express written consent.

All information contained herein is proprietary and is protected under copyright law.

Explore our site at [\*\*www.morganstanley.com/im\*\*](https://www.morganstanley.com/im)