Four Factors Driving U.S. vs International Equities

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Key Takeaways

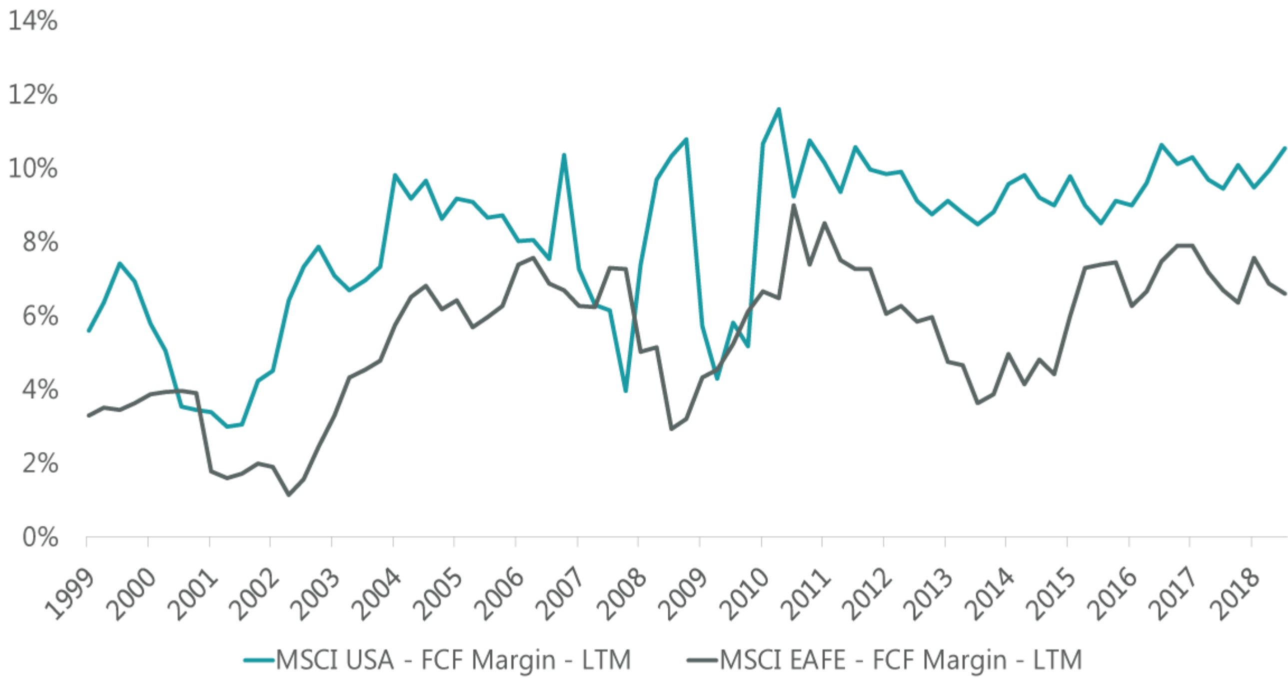
- The historical performance advantage of U.S. over international equities has expanded meaningfully over the last decade.
- We attribute the performance gap to 1) higher free cash flow, 2) higher share repurchases and 3) superior earnings of U.S. companies as well as 4) the growth-heavy composition of the U.S. equity market.
- A narrowing of these advantages, due partially to non-U.S. companies adopting many U.S. management practices, should also continue and potentially reverse the current stock performance gap.

Higher Free Cash Flows Drive U.S. Equity Returns

Over the past 30 years, U.S. stocks have outperformed the rest of the world by about 500 basis points on an annualized basis. This advantage has expanded over the last decade to 800 basis points. No single factor explains this historic performance gap as macroeconomic differences account for only a small portion of the underperformance of non-U.S. markets. Relative valuations are important to longer-term returns but in isolation provide little help in determining the timing and magnitude of relative performance cycles. We believe that four underlying factors have driven the superior gains in U.S. shares. Importantly, the relative expansion or contraction of these metrics align well with the relative performance of international equities.

The first metric to consider is the higher free cash flows of U.S. companies. Domestic stocks have enjoyed an average free cash flow margin premium of about 400 basis points over the past 30 years (Exhibit 1). When this gap contracts toward 200 basis points, relative performance improves for international markets, according to Empirical Research Partners. This last occurred in the decade of the 2000s.

Exhibit 1: U.S. Companies Generate Higher Free Cash Flow

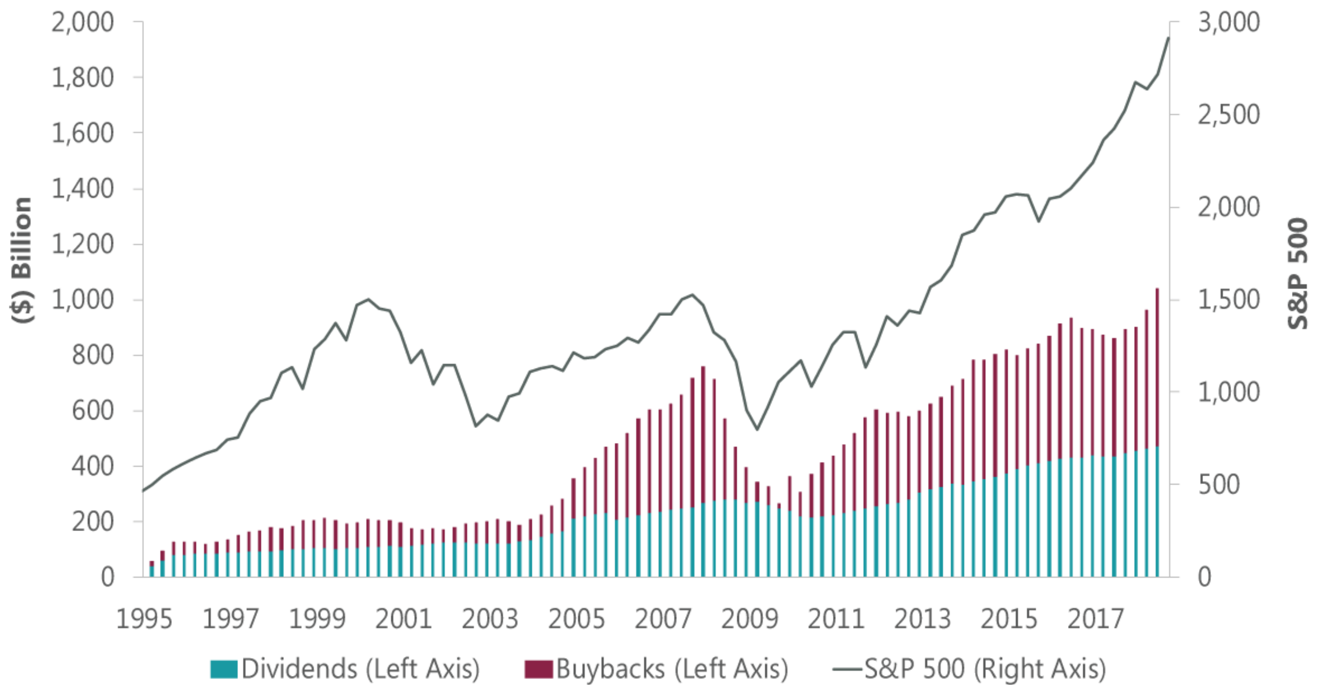


As of Sept. 30, 2018. Source: FactSet.

The combination of lower capital intensity and free cash flows leads to the second driver of U.S. outperformance: share repurchases. Over the past 10 years, American firms have been decreasing share count, while outside of the U.S., companies have been in net issuance. Empirical Research Partners points out that top share repurchasers have earned a performance premium of about 200 basis points historically.

A robust supply of private equity funding and record expansion of corporate debt has allowed U.S. public companies to reduce total market capitalization an average of 3% per year since 2008. This contraction contrasts with the annualized common equity expansion in Europe of 1.7% and is cited by Gavekal Research as a driver of the poor performance of continental shares. International management teams have tended to favor returning cash to shareholders via dividends, which has not been a consistent source of alpha over the past two decades.

Exhibit 2: Growth in Share Buybacks Has Fueled U.S. Stocks

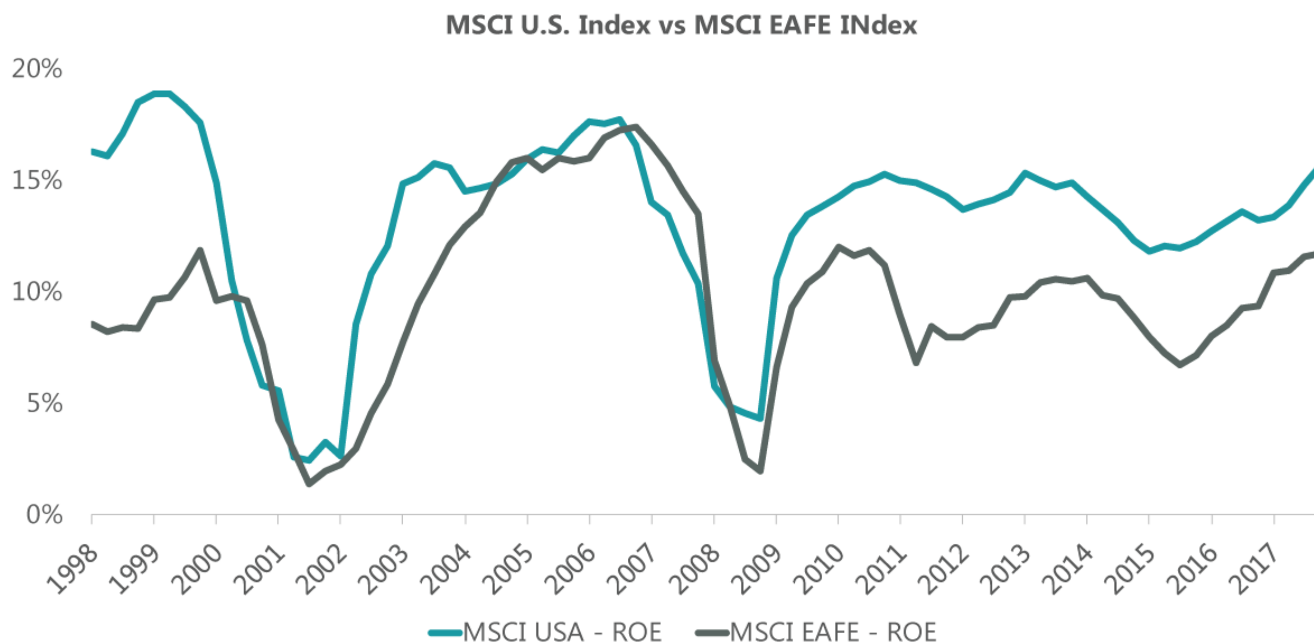


S&P 500 as of September 30, 2018. Remainder as of June 30, 2018, most recent available as of September 30, 2018. Source: Credit Suisse, S&P, Bloomberg.

Shrinking the equity base with the use of free cash flow and debt has served to support a third advantage for U.S. firms: superior earnings growth and returns on equity (ROE). This gap has widened significantly in the past decade, especially relative to Europe (Exhibit 3). U.S. firms have generally enjoyed a sales growth advantage over the past 30 years, but the last decade's divergence in earnings per share is unprecedented. This jump in relative profits occurred in the context of subpar global growth, powering an expansion in U.S. valuation premiums.

Historically, American companies have maintained a consistently higher ROE and relative share performance appears to correlate well with the contraction or expansion of this gap. In the 1990s, when the ROE premium averaged 900 basis points, the U.S. outperformed non-U.S. markets by an annualized 1,200 basis points as measured by a custom universe of large cap developed market stocks maintained by Empirical Research Partners. When this difference was cut in half in the 2000s, international markets posted relative average yearly gains of 260 basis points. In the most recent decade, U.S. ROE have climbed back to a 600 basis-point advantage, driving about 800 basis points of annual outperformance.

Exhibit 3: Return on Equity for U.S. vs. Developed Market Companies



As of Sept. 30, 2018. Source: Bloomberg.

Lastly, a large portion of the divergences we have highlighted can be attributed to market composition effects. The U.S. enjoys a higher weighting of "new economy" technology and growth stocks while the rest of the world has a much larger share of "old economy" financial and cyclical companies. Technology shares account for over 20% of the U.S. stock market as measured by the Russell 3000 Index compared with only a little over 6% in the developed international markets as measured by the MSCI EAFE Index. The parabolically rising "FAANGS" alone total about 11% of the Russell 3000, up from just 2% in 2008. This leads us to observe that when the proportion of the fastest-growing companies in the world domiciled in the U.S. is rising, international markets tend to struggle. Over the past decade the representation of U.S. firms in the top quintile of growth has expanded from 35% to approximately 80%, according to growth score metrics compiled by Empirical Research Partners.

Conclusion

Over the past three decades, the relative performance of international shares appears to have been driven by the directional shift in free cash flows, earnings growth and ROE as compared to U.S. companies. International shares outperformed during those periods when non-U.S. firms improved upon these metrics relative to American companies. For the most recent 10-year period, this dynamic has been amplified by the profusion of share repurchases in the U.S. and an investment environment characterized by a rising premium for secular growth stocks which American markets had in abundance.

Currently, international equities offer the largest free cash flow yield premium of the past 30 years and are at historically extreme levels of undervaluation relative to U.S. markets. In addition, there are initial signs that the key metrics we have outlined are beginning to shift in support of better relative share price performance for non-U.S. markets. The heavily weighted U.S. tech stocks have begun to underperform as earnings growth and margins fall short of expectations. Rising borrowing costs and record high corporate debt, meanwhile, have started to reduce the positive impact of share repurchases. Negative estimate revisions and lowered management profit guidance are becoming more frequent in the U.S.

Meanwhile, company managements in China, Japan, Europe and many emerging markets are emulating their U.S.

peers in focusing upon free cash flows, share buybacks and industry consolidation, which should improve capital returns in the future. On top of this, policy makers and central bankers are generally committed to reflation and economic stimulus that will eventually favor the “old economy” financial, consumer and cyclical shares that make up a relatively larger portion of the non-U.S. markets.

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- 35 years of investment industry experience
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