Two Million Miles and Counting: Martin Schulz Reflects on 20 Years of International Investing

October 2017

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It's difficult to encapsulate just how much the international investing arena has changed during the past 20 years. Along with the natural ebb and flow of economic cycles and geopolitics, we've witnessed major market-shaping events and the emergence of powerful secular trends that have dramatically shifted the international investment landscape. Not only have we been affected by large-scale economic developments, such as the advent of the euro, the rise of China, and the impact and fallout from the global financial crisis, but we've also witnessed sweeping changes to every aspect of our business due to the internet and other technological advances.

In a fast-moving environment where change is the only true constant, we believe the importance of maintaining a disciplined investment philosophy and process is paramount to success. Furthermore, the presence of constant change highlights the importance of performing on-the-ground research to help distinguish the signal from the noise. Despite gaining monumental efficiencies over the years—mainly through the influence of technology—we believe there is plenty of inefficiency left to exploit in international equities, due to the complexities of weighing company fundamentals against geopolitical and economic factors, among others. We believe our process, which combines the systematic evaluation of countries and securities with detailed fundamental analysis, is well-suited to this environment, as we are able to maintain a consistent approach while incorporating the dynamics of an ever-changing world.

A STRATEGY FORGED BY FIRE – THE 1997 ASIAN FINANCIAL CRISIS

Beginning in the late 1990s, we embraced international investing as a way to tap into the growing potential of foreign equity markets and provide an additional mode of diversification for our clients. But just as we launched our first international strategy in 1997, the global markets erupted in turmoil. In July of that year, speculative pressures led to a currency crisis in Thailand, a contagion that quickly spread to other East Asian countries. Banks across the region came under fire, capital flows dried up, foreign investment plummeted, and several East Asian economies went into recession.

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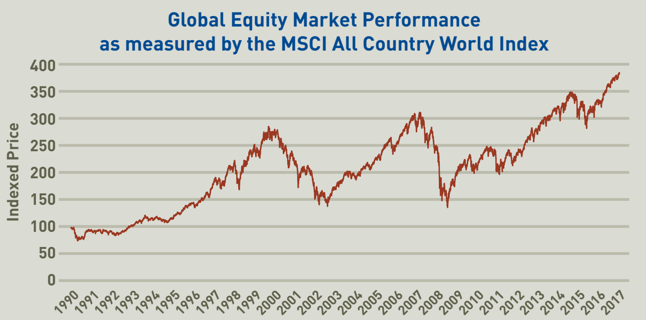
Globalization, which had been a driving force of so much economic growth and prosperity for so many, essentially rendered geographic borders meaningless, as spillover from the crisis extended around the world. Eroding confidence in emerging economies caused Russian financial markets to tumble, leading to a devaluation of the ruble and to Russia defaulting on its debt. The Asian financial crisis also sparked a near-crisis in the U.S., as massive losses at the former hedge fund mammoth, Long-Term Capital Management, ultimately required the Federal Reserve to step in with a bailout to stem the bleeding and prevent further catastrophe.



Source: FactSet, Dates: May 31, 1990 to September 29, 2017.
Past performance is not a guarantee of future results.

The lessons we learned during this time helped shape our investment approach, notably in terms of market valuation and risk considerations in stock selection and portfolio construction. We saw richly valued stocks in countries with large current-account deficits and overvalued currencies fall dramatically in price as the havoc unfolded. The impressive growth of many East Asian economies had cloaked very serious weaknesses: rapid credit expansion and poor financial oversight had led to highly leveraged companies and questionable loans. Overheated East Asian economies relied heavily on foreign borrowing, often at short maturities, and swelling current account deficits added significantly to the region's vulnerabilities. The Asian financial crisis underscored the importance of valuation and risk assessments in our top-down decisions to overweight and underweight countries.

EVENTS AND TRENDS OVER THE LAST 20 YEARS

Since that eventful beginning, we have navigated the many ups and downs, as well as the sheer complexity inherent to international markets, by relying on our disciplined process as our compass. The global economy and financial marketplace have experienced explosive change over these last two decades. There have been many seminal events, including:

The formation of the euro in 1999 – When 11 European Union (EU) nations adopted a single currency, it represented the first time since the reign of Charlemagne (who ruled over much of Western Europe from 768 to 814) that a significant part of the continent shared a common monetary system. Aside from making our lives administratively and logistically easier because we no longer had to deal with a plethora of different currencies (i.e., francs, lira, marks, etc.), the advent of the euro allowed us to invest in Europe on a pan-regional basis. While we continued to analyze each separate country for potential risks, we became better able to invest across the region in companies that offered long-term growth and capital appreciation.

China's economic ascent – China's acceptance into the World Trade Organization in 2001 marked a significant step in the country's evolution toward becoming a major economic power. Not only did China lead the developing world in contributing to global economic growth, but for the first time our team was able to begin to closely look at the burgeoning opportunities the Chinese markets had to offer. Since then, China has become a powerful growth market for us, as we've been able to make investments in fast-growing industries, such as consumer goods and services, technology, and industrials.

Germany's economic rebirth – At the turn of the century, Germany was considered the "sick man" of Europe, plagued by high unemployment, declining productivity, and anemic growth. Today, the country enjoys near-hegemonic status on the continent and is viewed as the economic engine of the EU. Our team was underweight Europe from the beginning of the new millennium until 2010, as we found greater growth opportunities and less risk elsewhere, especially in Asia. But then a curious thing happened. The structural reforms under Germany's Chancellor Schroeder began bearing fruit, and by 2011 Germany and Europe were finally showing promise. Valuations were more compelling, the currency was competitive, and trade balances were positive. Our investments in health care, financial, and consumer goods and services companies provided the growth we were seeking for our clients, but without the valuation or market risks previously encountered.

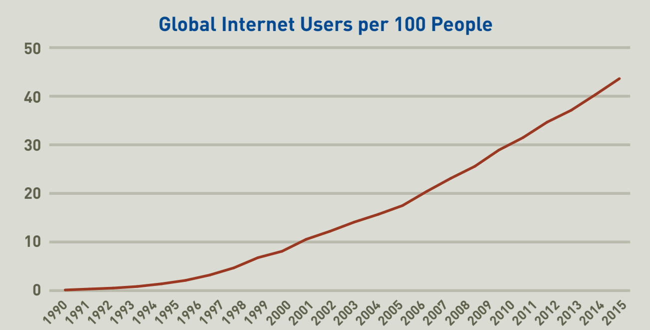
The global financial crisis of 2008-2009 – The economic onslaught from the global financial crisis caused international monetary authorities to use unprecedented easing measures to fight deflation. Europe felt strong aftershocks, as the region's sovereign debt crisis underscored already simmering political disunity. The euro crisis that followed presented the region with a serious challenge to its monetary union, as struggling economies challenged the membership to cope. The use of unprecedented global monetary easing meant that companies with earnings growth, pricing power, and innovative business models would flourish in a low-growth world. From a top-down perspective, we continued to meet with our contacts at various finance ministries in Europe, including the ifo Institute for Economic Research and the European Central Bank, and by 2011 determined that European policy makers would do "whatever it takes." Our investments subsequently shifted more toward the region.

By relying on our disciplined process over the years, regardless of popular trends, current events, or unexpected shocks, we ensured our team was shielded from the "noise" and instead focused on what was important to drive long-term returns.

Perhaps more important to the evolution of our investment opportunity set over time is the role that long-term secular trends have played in shaping today's global environment. Several important themes have emerged, including:

Globalization – The past two decades have witnessed the growing integration of trade, financial markets, and labor in the world economy. The cross-border movement of goods and services, capital, and people has expanded relentlessly, sparking advances in communications, transportation, innovative technologies, and process automation. Our team continues to identify companies that require less capital but are nevertheless global players, whose processes and technology can generate strong earnings growth and above-average returns.

Ubiquitous mobile and internet connections – Technological advances have made mobile devices more powerful, smaller, and affordable. Additionally, e-commerce is massively altering the consumption landscape. Our team has identified companies throughout the globe that allow consumers anywhere in the world to bank, buy, research, communicate, and share from their smartphone. Technology has had a profound effect on our business too, due to the ability to communicate from nearly anywhere in the world and share information across borders in real time.



Source: UNData web site, http://data.un.org/Data.aspx?d=WDI&f=Indicator_Code%3AIT.NET.USER.P2

Shifting demographics – The developed world is aging fast. Led by Japan, most advanced economies have been grappling with high debt, declining economic growth, rising unemployment, higher health-care costs, and lower productivity. On the other hand, the developing world enjoys strong demographic tailwinds with higher economic growth, strong employment, increasing urbanization, and rising infrastructure and investment spending. Over time, our team has slowly increased our exposure to emerging markets, especially through companies tied to consumption. In our view, Southeast Asia and Eastern Europe currently provide compelling opportunities to invest in growth companies located in markets with lower valuations, less risk, and higher growth.

WHAT'S NEXT? EXPECT DEVELOPING ECONOMIES TO TAKE A LARGER ROLE

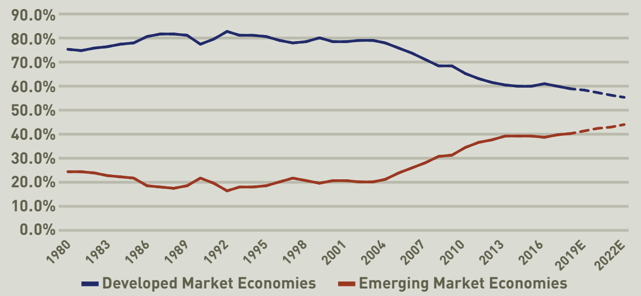
During the past 20 years, we have seen emerging markets begin to take their rightful seat at the global economic table. According to the International Monetary Fund (IMF), developing countries now account for close to 80% of global economic growth, almost double their share two decades ago. In its 2017 World Economic Outlook, the IMF forecasted developing economies to grow more than twice as fast as developed nations. We expect developing economies will continue to grow at a faster rate than advanced economies for the foreseeable future. As a result, these nations will account for an increasing share of the global economy, but more importantly, expanded potential investment opportunities.

As we recognized this unstoppable trend, we began increasingly investing resources to expand our capabilities in the developing world by adding team members who are dedicated to those regions. Emerging economies are not one large monolithic market. We expect selectivity—both of geographies and securities—will continue to be the key to successfully investing in these markets. We believe our top-down country allocation framework optimally lends itself to analyzing and differentiating between markets by identifying those with the most compelling valuations and the least amount of risk.

The investable universe of companies within emerging markets is no longer restricted to manufacturing companies and natural resource suppliers as it once was. Furthermore, rather than relying primarily on exports, developing economies have become increasingly important as final destinations for goods and services, and they now account for close to 85% of the growth in global consumption.[1]

As economies have expanded and discretionary incomes grown, changing consumer needs and demands have created new opportunities for a number of industries, including technology, infrastructure, and retail, among others. Attractive demographic trends will also continue to create opportunities in emerging markets. Large numbers of young people in these countries are joining the workforce, resulting in growing demand for consumer goods, mortgages, and education. That's positive, although it will put pressure on these growing nations to evolve from export-oriented industries to more balanced economies supporting middle-class lifestyles.

Developed vs. Emerging Economies
Group GDP as a Percent of World GDP



Source: International Monetary Fund, World Economic Outlook Database, April 2017

Unlike most emerging economies, we expect developed economies will continue to confront aging populations, growing social welfare costs, high levels of debt, the need for major infrastructure spending, the impact of automation and job displacement, and the need for appropriate immigration policies. As noted, growth rates will likely be well below those of successful emerging economies.

THE PATH FORWARD

We expect global markets will be increasingly impacted by forces, as described by early 20th century economist Joseph Schumpeter, of "creative destruction." All the elements that helped shape the opportunities in today's international investing arena—enhanced global trade, ubiquitous internet connections, and widespread adoption of social media, among others—will also contribute to an increasingly intense competitive environment. We expect many traditional industries and businesses may find it difficult to adapt. On the other hand, we believe this will create opportunities for nimble businesses in attractive regions that have clearly defined strategies, strong management teams, earnings growth potential, and high-quality balance sheets.

Navigating the great many risks in international markets will continue to be key to generating long-term excess returns. Technological advancements, geopolitics, and shifting demographic trends all represent risks. The rise of nationalist populism in western democracies and developing countries alike is strongly associated with protectionist impulses that could threaten global trade. Additionally, geopolitical unease and stress over increasing income inequality will continue to impact the global economy in the years ahead. However, we believe the prospects and opportunities for international investing are bright, especially in fast-growing emerging markets. As we look to the future, we may not know what exactly lies ahead, but we are confident that our time-tested investment process will provide the roadmap—as it has now for two decades—for years to come.

[1]International Monetary Fund. *World Economic Outlook April 2017, page 67.* Washington, D.C. 2017.