

# INSIGHTS

## INVESTMENT



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## Is it time for international value to shine?

Institutional investors have benefitted from buoyant stock markets around the world this year, but in some markets — the U.S., for example — valuations are getting pricey. Paul Ehrlichman, a managing director, head of global value and portfolio manager at ClearBridge Investments, discusses equity valuations around the world, how he and his team find investment opportunities, bond zombies and why he thinks value investors are better suited for today's environment.

**Pensions & Investments** | *Where are you seeing the largest discrepancies between stock prices and intrinsic value?*

**Paul Ehrlichman** | From an overvaluation perspective, we find companies in the U.S. generally 50% to 100% more expensive than their international peers. Shares in India also appear to be a bit expensive. From a sector standpoint, utility, food and beverage, and technology stocks are expensive.

Our biggest overweight is in Europe, roughly half the portfolio. In Europe, for the first time in a decade, we are seeing profit estimates rising, while in the U.S., they are falling. It is very unusual that Europe is doing better from a profit standpoint.

**P&I** | *How long have you been overweight in Europe?*

**Ehrlichman** | It started about four or five years ago. Our focus then was to buy companies in Europe that had nothing to do with Europe. Now we are buying companies that do business within Europe. Back then, energy stocks, global exporters, auto companies and technology companies that were in Europe were punished for being European, and while we were not optimistic about the situation in Europe, they were doing most of their business outside of Europe.

Today, people are very excited about the big industrials [in Europe] and our shift internally is a little bit more to the peripheral and more of a focus on domestic demand plays — construction, housing, some retail and apparel, luxury goods, employment services companies and local providers of furniture and housing-related items.

**P&I** | *What is the breakdown of the rest of the portfolio?*

**Ehrlichman** | Asia ex-Japan is 6%. Emerging markets is 17%. In those markets, we are moving toward more [companies with] domestic demand and toward mid- and small cap. Japan is 12%. Profits in Japan are at record highs and the country appears to have exited a 25-year period of underperformance and stagnation. Share prices have yet to reflect this as a sustainable trend, and as

a result, we are finding a significant value opportunity in a range of Japanese stocks. The U.K. is 15%. The U.K. reflects a lot of exporters. We're not particularly optimistic toward the U.K. domestic economy.

**P&I** | *What about China?*

**Ehrlichman** | The real story in China is reform and the state-owned enterprises and the premiumization of the economy, which is very powerful. We are more oriented toward domestic demand and pharmaceutical names. The One Belt One Road initiative plays as well, so anything to do with smart buildings, energy efficiency, etc.

**P&I** | *Tell us more about your views on Europe and Japan.*

**Ehrlichman** | Europe is doing very well from an earnings standpoint and growth in the domestic economies is normalizing. The Southern European countries are catching up with the North, so we're getting balanced growth driven by fundamentals as opposed to distortions from central banks.

The switch we're making now is we're buying companies that do business within Europe and are very European. We're getting more optimistic about Japan. We're finding the best values in industrial cyclical companies and technology companies. And we're seeing a more positive domestic demand environment, with the number of

workers in Japan at the highest level ever.

Japan was in a classic debt trap where their real interest rates were higher than their growth, and they had to keep taking on debt. That's now reversing. GDP growth is greater than real interest rates and corporate profits are booming, so they're going to start paying down debt.

We're increasing our weighting in Japan.

**P&I** | *In determining where you are going to invest, and what you are going to invest in, do you start with a macro view?*

**Ehrlichman** | We start with an objective value screen. It is very robust. It takes us from about 5,000 liquid stocks to about 1,500. It points us toward only those stocks in the world that are selling for less than normal.

**P&I** | *What do you mean by less than normal?*

**Ehrlichman** | I mean normal for that company. We look at the P/E, price-to-book and price-to-cash flow relative to its own history, its sector and its country. There are nine measures to define normal and we average them out. If the company is selling below its own norms, we look at it. Much of what screens cheap is a potential stinker or a value trap or has some structural impairments.

Before we get excited about the upside, we do a deep

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## Investments

dive. We look at the management, the competitive position of the company, the balance sheet and the state of the industry. We don't buy companies that are losing market share because that means something is wrong.

**|P&I| How are stocks reacting to earnings as opposed to multiples?**

**|Ehrlichman|** We've been in the most multiple-driven bull market in history, particularly in the U.S. Normally stocks go up some multiple of GDP growth, for example, two to three times. In the U.S., that's closer to eight times. For the last two years in Europe and Japan, earnings have recovered but we have not seen multiples expand.

This is one of the reasons value stocks had mixed-to-negative performance over the last couple of years and par-

strong. This would be a rotational correction out of U.S. stocks and the extended FANG-type of companies [Facebook, Amazon.com, Netflix and Google, now Alphabet].

On the other hand, if stronger global growth were to cause an inflation shock or a sudden adjustment in government bond prices, investors might believe that central banks are behind the curve and begin to discount a sharper rise in short-term interest rates. The fear of going directly from stagnation to stagflation would cause a rise in stock correlations around the world. While I believe that U.S. stocks would fall to a greater degree than international shares, this would lead to a global correction in equities.

My bet is more on the orderly and more rotational scenario as bond investors — zombies — continue to pour

**Korea affecting Asian stock markets? How are you navigating that?**

**|Ehrlichman|** In general, there is really no way to react to the fear of the potential of war, particularly of a thermonuclear nature. Over the last three months, we have taken our weighting up in South Korea. The opportunity in South Korea is really to rotate into things like financials. We are taking our non-Japan weighting up and our Chinese weighting up.

We are kind of weighing into these markets because emerging market value stocks and Asian value stocks have actually done quite poorly, and I think it is a reflection of these concerns. It is a great opportunity because I think once the dust settles, Asia will be stronger.

**|P&I| How do you avoid overconcentration?**

**|Ehrlichman|** One of the little secrets of value investing is that when you run value screens, sometimes the portfolio unintentionally becomes about one thing, so we have some rules. No more than 35% of the portfolio can be in one industry or sector, and no more than 35% in a single country. We don't want to have more than 5% in an individual stock. The range is more 1% to 3%.

**|P&I| What are the limitations of international value indexes, and what might investors be missing by using a passive strategy?**

**|Ehrlichman|** They are getting what is cheap. They are not getting what is cheap on a stock basis, they're getting what's cheap in the aggregate. So many of the value indexes are just using P/Es or price-to-book or price-to-cash flow. You are going to get low quality, and we know that is not a great factor over the long term. You get unhelpful sector concentrations.

Because it is just screening, it's not looking at fundamentals and where we are in the cycle. You can get volatile return patterns that are tough to live with. If you said, 'I'm going to buy a value index fund and I'm going to keep it for 35 years,' then I would say, 'OK, that might work.' But what people are more likely to do is let it run for five or six years after they buy it and then bail after it collapses.

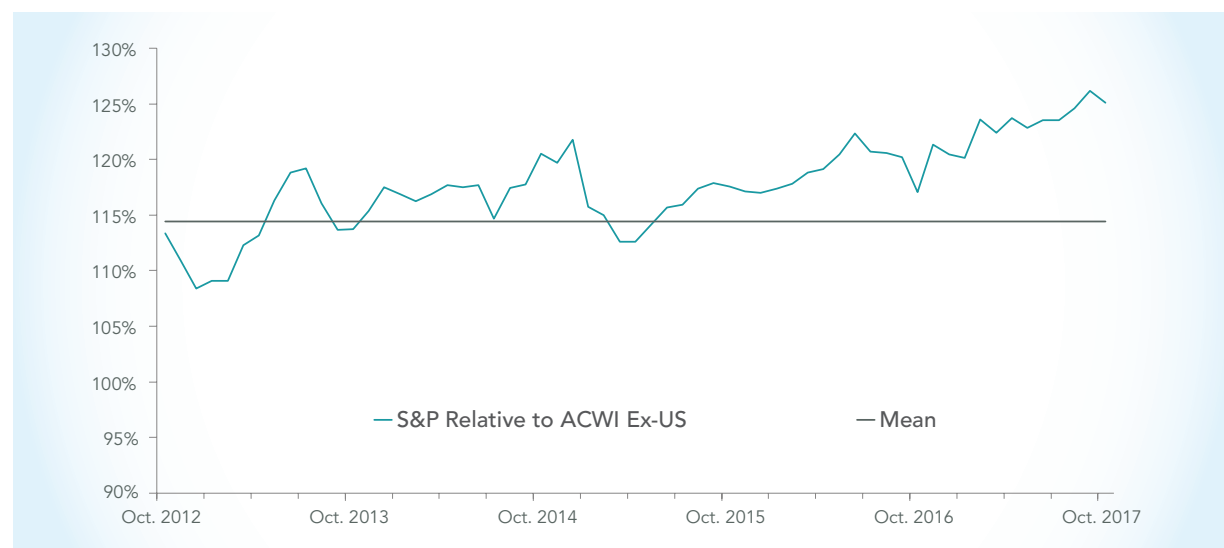
**|P&I| But index funds are getting the lion's share of investor dollars and investors are benefitting. What's going on?**

**|Ehrlichman|** We're at one of those points in time where active tends to do better relative to passive. It's correlated with a normalizing interest-rate environment after an extraordinary period of interest-rate decline. So if you believe rates are going to normalize, that the yield curve is going to normalize and rates are probably going to rise over the next decade, that will be in an earnings-driven environment, which means we'll generally have a growing economy.

Those factors, historically, have favored active management over passive. We are seeing evidence of that. Even with the FANGs doing well, high passive ownership is starting to underperform.

When interest rates are no longer falling, you want active management because we do certain things better. We do better in earnings-driven environments, and we can shift away from crowded and expensive assets. ■

## INTERNATIONAL VALUATIONS: STILL ATTRACTIVE VS. THE U.S.



Source: Bloomberg as of Oct. 31, 2017

ticularly this year. There's definitely not investor buy-in yet in the degree of operating leverage and the sustainability of this synchronized global recovery.

We think there's a tremendous opportunity in the cyclical side of the market and honestly, it's the only thing left.

We do believe we're shifting to an earnings-driven environment that favors companies that can maximize returns on current production as opposed to financial engineering. We're not going to drive multiples higher through share repurchases and interest rates that have gone to zero. People have squeezed all the juice out of that lemon.

**|P&I| What happens to international markets if or when U.S. stocks begin to decline?**

**|Ehrlichman|** The U.S. is the most extended and overvalued stock market in the world due to high exposure to momentum-driven shares, especially in the tech sector. The U.S. also has benefitted the most from non-earnings-driven stock price gains, i.e., multiple expansion, and is now displaying the lowest earnings growth in the world outside of the tech sector. International shares could continue to outperform as the global economic recovery broadens and non-U.S. corporate profits are

money into sovereign debt despite signs of a synchronized global recovery and reflation. Average annualized real returns, as measured by the Barclays Global Aggregate Bond Index, have been negative for the past five years but this does not seem to deter bond investors, hence the zombie moniker.

**|P&I| How important is a multinational company's home base?**

**|Ehrlichman|** When we look at a company, we have to step back and say, 'What are the local things that affect this company? Are they an exporter? Will local labor and local laws and local infrastructure affect them or are they like Honda in Japan?' Honda builds 95% of its cars in the United States. The labor shortage in Japan is meaningless to them.

If I have a coffee company or a restaurant or a food distribution company or a retailer or housing company or a cement company — that's very local. Then I have to understand what is going on in that local economy. Sometimes we have to understand the regional economy when we get into small cap.

**|P&I| How is the crisis between the U.S. and North**

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