

International Equity Investment Outlook

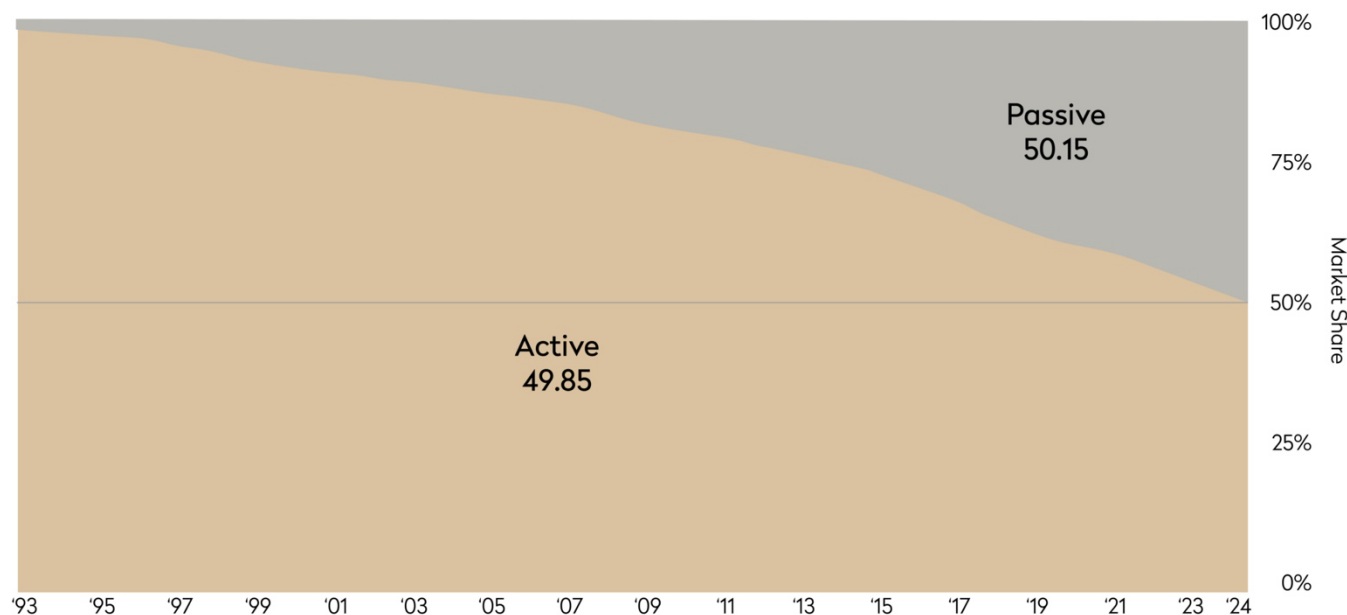
Earlier this year, a debate broke out among investors on the significance and impact of passive investing on equity markets and their role in long-term price-discovery in financial markets. Several investors laid blame on passive strategies for the possible distortions – concentration and valuation – experienced most notably in the US equity market. Investors also commented that significant passive ownership and activity was causing them to re-evaluate their investment processes and their approach to alpha generation. With the distortions of the COVID pandemic behind us we thought it was a good time to stop and be reflective on the evolution of markets and the interaction with our investment process.

- Are passively held assets large enough to impact price discovery in markets?

The chart below was published by Morningstar at the beginning of the year triggering a debate among some high-profile investors over the impact of passively held investments on markets. Passive investing has been growing for decades, but it appeared to pass a milestone at the start of 2024 when Morningstar reported that the passive share of mutual funds and ETFs had tipped over 50%. Though it is worth acknowledging that other data sources had previously put this milestone as far back as 2019.

Market Share: All Funds

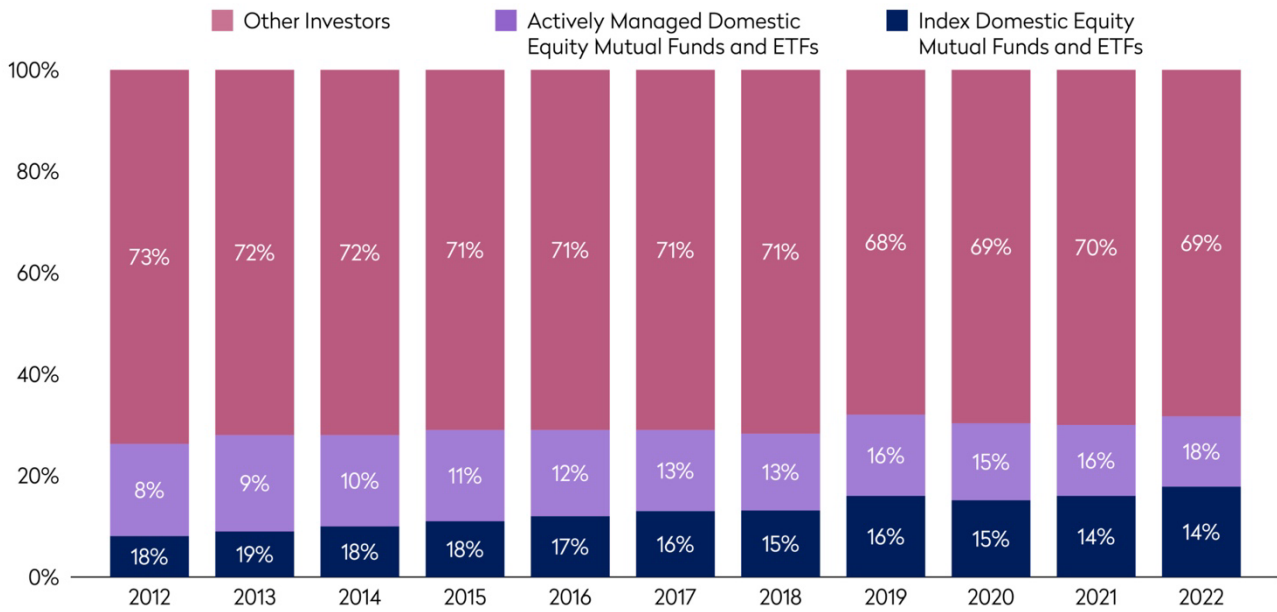
Active vs Passive market shares, all long-term mutual funds and ETFs, Feb. 1, 1993 - Jan. 1, 2024



Source: Morningstar

Like Morningstar, most data sources tracking US passive investing consider only domestic pooled vehicles, such as mutual funds and ETFs, on which there is good disclosure. From this data, passive ownership of the US equity market is typically calculated to be 15-20% of total market value, with the remainder held by pension funds, life insurance companies, foreign investors, businesses, hedge funds, households and active mutual funds.

Fund Share of US Stock Market

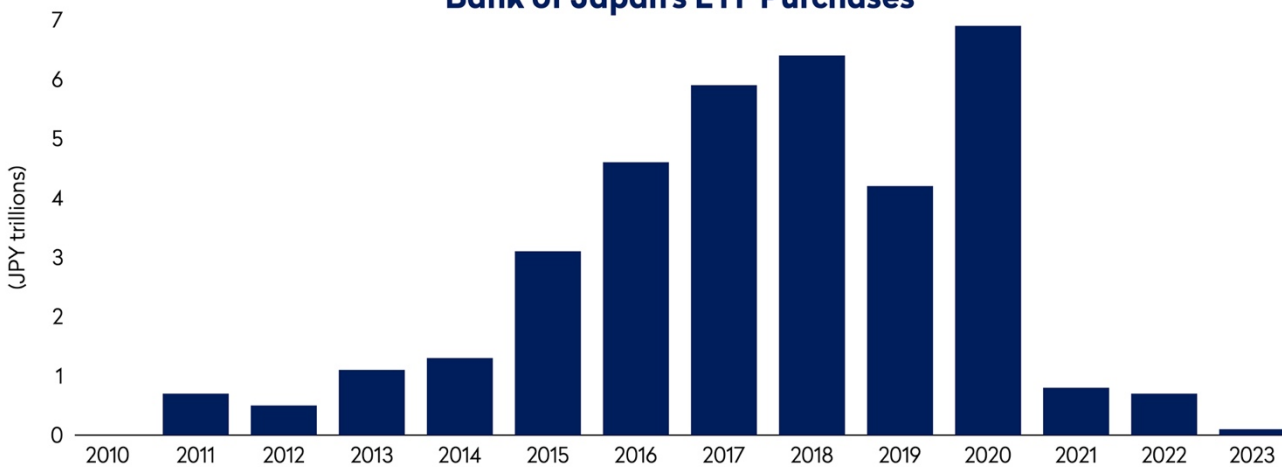


Source: Investment Company Institute and World Federation of Exchanges

However, getting to the true scale of passive investing is tricky, since it is hard to track the many institutions who execute their passive strategies internally or via bespoke separately managed accounts. A Blackrock report in 2017 put institutional and internal indexing at more than double the amount in pooled vehicles at the time. More recent research by Harvard Business School¹ has attempted to back into the total size of passive investing by looking at the volume of trading in stocks as they are added or removed from indices. The conclusion was similar to the Blackrock data: that passive ownership of the US equity market was roughly double that in pooled vehicles, implying up to 40% of the overall market.

Although the US market is believed to have the largest proportion of passive assets, in Japan, the role of passive investing or non-price-setting assets has been a particularly acute issue for a couple of reasons. Firstly, ETF purchases have played a significant role in the Bank of Japan's quantitative easing program. It first started buying ETFs in 2010 with the aim of halting asset price deflation.

Bank of Japan's ETF Purchases

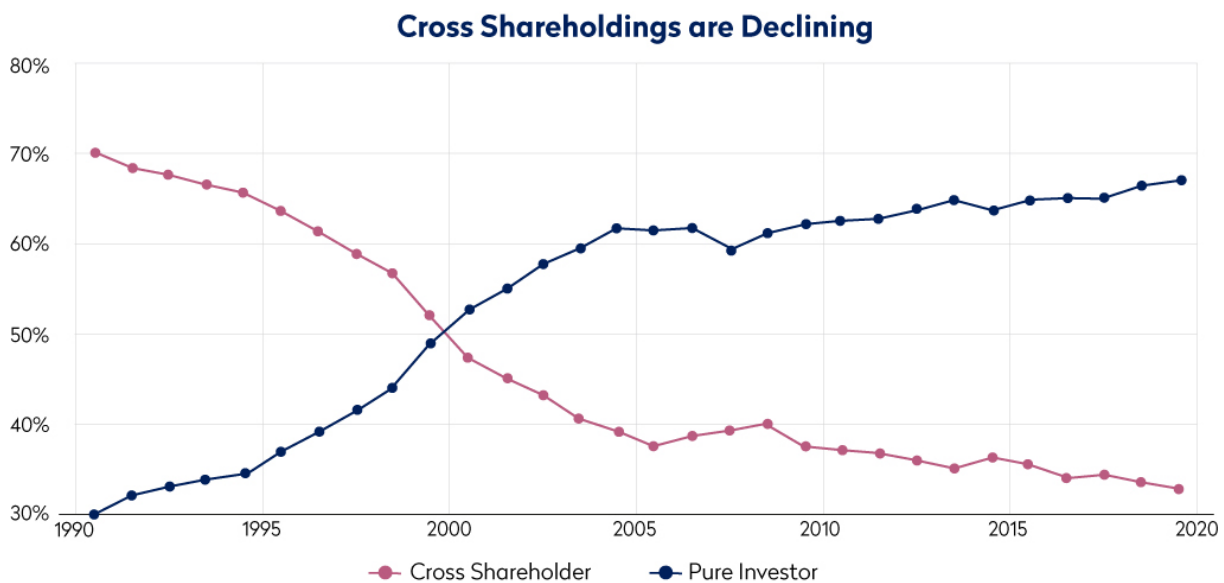


Source: Bank of Japan

¹Chinco, Alex, and Marco Sammon. "The Passive-Ownership Share Is Double What You Think It Is." Working Paper, Harvard Business School, May 2023

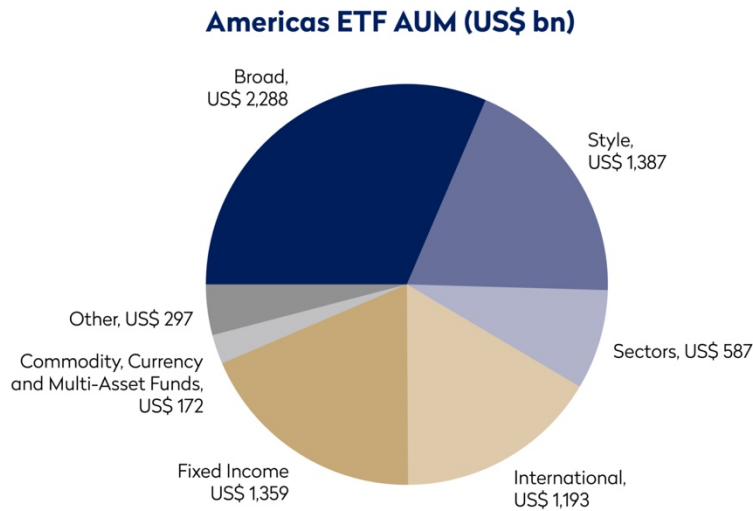
While the Bank of Japan formally decided to end its ETF buying in March 2024, having already suspended purchases five months earlier, it is estimated to hold circa 90% of Japan ETFs and 7% of the TOPIX market capitalization, creating concerns among investors around potential market distortion.

Secondly, a long-standing and unique feature of corporate Japan is the widespread use of cross-shareholdings. These cross-shareholdings were initially introduced to promote closer collaboration between Japanese firms in the wake of WW2. This initiative, while not without its benefits, has led to a significant share of passive ownership in the Japanese market as well as giving rise to corporate governance concerns. While cross-shareholdings, driven by a wide range of corporate governance reforms, are on the decline, they still constitute a sizable proportion of the aggregate market: according to analysis by Nomura, strategically held shares (which incorporate both cross-shareholdings and the government's ownership via ETFs) represent circa 30% of the Japanese market. This underestimates the passive or non-price-setting exposure in the market as it does not include holdings in index funds by institutional or retail investors.



Source: Nomura. As of 2020. Cross shareholder includes government, corporate, financial institutions and investors holding >10% total shares outstanding

One other factor to consider when assessing the size and impact of passive funds on equity markets is what exactly is in the passive bucket. Although we may picture passive funds as being directed towards broad market exposures, such as the S&P 500, more than half of US ETF assets under management are tracking narrower exposures such as specific sectors, countries, styles, and market capitalization ranges. These more nuanced allocations by investors may include an active decision and reflect a view on fundamentals or valuations, but may also actively distort valuations. Given the complexity of passive assets it is clear that it is increasingly difficult to view passive and active assets as two separate buckets of assets. Interestingly bottom-up research by Bloomberg looking at ownership of individual stocks showed that passive ownership was highest in small and mid-caps that pay dividends and demonstrate value traits; utilities and REITs were the top sectors.



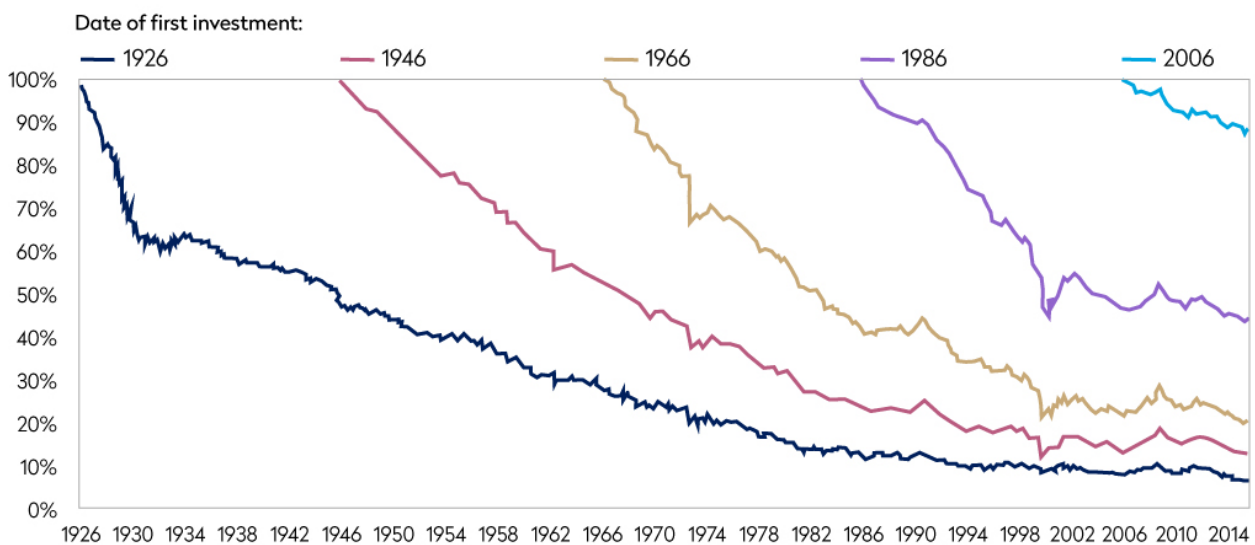
Source: JP Morgan Quantitative and Derivatives Strategy, Bloomberg Finance LP. Data as of end of May 2023.

- Trading volumes an alternative metric to assess passive investors' impact

Public equity markets offer substantial public goods: low costs, transparent prices, and accessible liquidity. They also play a price discovery role for global financial assets. Should we be worried that all this passive money is now distorting the market and impairing its ability to undertake this important function? In assessing this, it is possible that the impact will depend not on the quantum of passive assets, but rather on their share of trading volumes.

Although funds tracking indices are defined as “passive,” the reality is that these funds are regular traders in the market due to asset flows, dividend reinvestment, and rebalancing for changes in the underlying indices. Even with no asset flows, an investor who bought the US market in 1966 and then did nothing would own less than 20% of the market today. Indices are seen as a neutral benchmark for active managers, but the passive funds trying to mirror them require significant management.

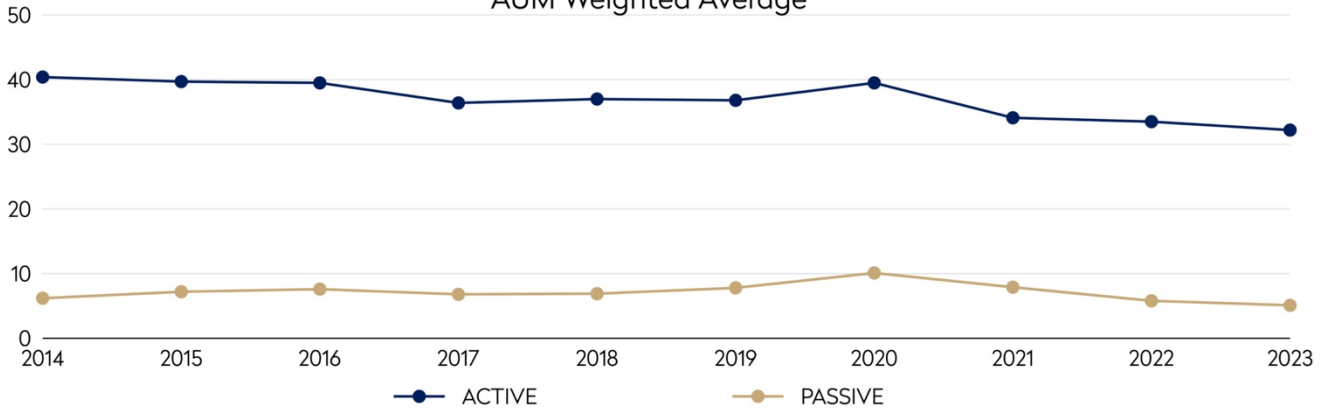
Fraction of the US Stock Market Owned by a Truly Passive Investor Over Time



Source: Lasse Heje Pedersen (2020), “Sharpening the Arithmetic of Active Management”, Financial Analysts Journal, 2018.

Passive funds may not be totally passive, but their turnover, typically less than 10% including flows, is significantly below the average actively managed US equity mutual fund in Morningstar’s database at over 30%. Other short-term traders in the market lift the overall turnover for the S&P 500 to over 70%². This means that the share of equity trading from passive funds relative to active is likely still relatively modest compared to assets.

US Equity Mutual Funds Turnover
AUM Weighted Average



Source: Mondrian Investment Partners; Morningstar

Despite this broad conclusion, getting real insight on how much passive investing is impacting equity market trading is very difficult given how congested the market is with large volumes linked to high frequency traders, other quantitative strategies, and derivative hedging.

- Increasing concentration and valuation makes passive investing a riskier proposition today

Markets are dynamic systems and while it is unclear if the rise of passive investing is distorting markets, markets themselves have altered the nature of passive investing today. The weight of the ten largest stocks in the MSCI ACWI at 19.5% is radically higher than anything seen for decades. Passive investors, rather than getting broad equity market beta, are increasingly making a call on the future of a handful of companies.

Global Stock Markets are Increasingly Concentrated
Weight of the 10 largest stocks in the MSCI ACWI (%)



Source: MSCI

²Defined as half the annual trading volume relative to market capitalization

The concentration is almost entirely driven by the US market where the issue of concentration is compounded by the significant business overlaps between the largest companies. Microsoft, Amazon, and Alphabet all have sizeable cloud computing operations. Nvidia, Microsoft, TSMC, and Broadcom have benefited recently from the excitement around AI. Meta, Alphabet and Amazon rely on digital advertising and the growth of ecommerce. Apple generates a meaningful proportion of its profits from its search agreement with Alphabet. These companies are all prized by investors today for their structural growth, but it highlights the vulnerability of index investors to a somewhat narrow, albeit large, set of end markets.

Furthermore, it is these large companies that have driven a lot of the re-rating of US equity markets over the last 10 years. At the end of 2014, the S&P 500 traded at a forward PE multiple of 16x, very similar to the equal-weighted S&P 500 at 16.3x. Today, the equal-weighted index is still close to this level at 16.7x, but the standard S&P 500 now trades at almost 21x. Some premium is arguably justified for the growth and quality of these companies – and we see good value in a few of them – but this starting valuation premium may present another challenge to passive investors expecting to replicate the success of the previous 10 years. Being discerning among these highly valued behemoths is more important than ever.

Larger Capitalization Stocks Have Driven the US Equity Market's Multiple Higher NTM PE Ratio of Standard S&P 500 and Equal-Weighted



Source: FactSet

- Mondrian's approach remains robust to a changing market environment

Some investors have called out passive investing as a reason for their strategies not working. The accusation is that markets are structurally broken since value is not a consideration for passive investors. Frustrated by an apparent lack of other fundamental investors willing to put a higher multiple on the stocks they own, some have decided to change their investment strategies. This has required a shift in how returns are generated, away from exit multiples and towards the generation of cash flows directed at shareholders such as buybacks and dividends.

This inherently makes sense to us and provides validation of our long-held investment philosophy which is based on the simple premise that the value of an asset is equal to the present value of the future cash flows associated with that asset. Accordingly, we use a dividend discount methodology consistently across all of our equity products to value securities.

Our model is flexible in nature, allowing us to incorporate not only dividends, but also share-buybacks which manifest themselves in a decline in the number of shares and a commensurate increase in proportionate entitlement to future dividends per share. The model is also flexible with regard to realization of future return. It can be achieved through capital appreciation and/or through cash return to shareholders. We do not have to rely on selling out of our investments at any particular multiple. Instead, we invest on the basis that our return can

also come directly from the future dividend stream associated with that security. As such, our focus is on analyzing the future underlying operating performance of the businesses in which we invest to determine what the long-term earnings, cashflow and ultimately dividend flow is expected to be and to use scenario analysis to understand the risk around that flow. This also highlights why we are not standing still: we continuously work to improve our processes by enhancing the reliability of our forecasts, strengthening our assessment of risk, and improving the quality of our investment decisions, while remaining true to our investment philosophy which we view as timeless given the focus on cash returns to shareholders.

- An increasingly passive market could present opportunities for Mondrian

Given the increased concentration in equity markets and lofty valuations on many of the largest companies, passive investing presents a very different, and arguably riskier, proposition today, than over the past ten years.

In addition, the growing share of passive investing could potentially impair price discovery in equity markets and increase volatility. This could pose a significant challenge to many investors relying on price-based signals, but should create further opportunities for active valuation-oriented managers. The rising passive share will not change the cash flows companies produce nor the right of shareholders to receive them. Instead, increasing market distortions and a more pronounced mispricing of securities would create a conducive environment for strategies focused primarily on bottom-up stock selection. As such, we believe that, rather than being challenged by the rise of passive investing, Mondrian's focus on dividends positions us well to take advantage of any further distortions in market pricing.

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