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EQUITIES | GLOBAL INVESTING | OUTLOOK

2023 Investment Outlook: International Equity

By: EV Forward | December 15, 2022

High-Quality Compounders Offer Recurring Revenues and Pricing Power

KEY POINTS

1. Companies with pricing power and recurring revenues that can grow their earnings steadily in real terms across cycles are likely to outearn the market.
2. The sharp compression in the valuation of higher-growth stocks has provided the opportunity to add some new names to the portfolio.
3. High-quality compounders with recurring revenues and pricing power should protect revenues and margins in a downturn.

What We Are Seeing

The MSCI World Index forward P/E multiple is more in line with the average from 2003 to 2019 (before COVID), shifting our focus to the vulnerability of broader market earnings.

Recent client meetings suggest that many asset owners have been reducing exposure to higher-growth stocks and are drawn to the more defensive characteristics of high-quality stocks.

We believe now is a particularly good time to own compounders, since their pricing power (the ability to pass on costs to consumers) and recurring revenues (the propensity toward repeat purchases) can make their earnings resilient in tough times.

High-quality compounder companies that can grow their earnings steadily in real terms, across cycles, are likely to outearn the market, just as they have done over the last few decades. When supply normalizes (or possibly even overbalances into excess supply), true pricing power comes into its own.

Investing in companies with true pricing power is crucial because earnings should be relatively resilient in a squeeze on the wider market's profitability.

What We Are Doing

We continue to focus on high-quality compounders regardless of the market backdrop.

Among these are favorite consumer brands, mission-critical software services and quality-assured health care companies that possess strong intangible assets, which are generally difficult to recreate or duplicate by competitors.

The sharp compression in the valuation of higher-growth stocks has provided the opportunity to add some new names to the portfolio and has influenced the additions and reductions within our global portfolios this past year.

What We Are Watching

There are two ways of losing money in equity investing: either the earnings go away or the multiple goes away. The main risk we see ahead is earnings. However, with forward earnings expected to rise over the next year and margins close to record levels, we do not see earnings signaling a significant economic slowdown, let alone a serious recession. Meanwhile, current derating of some stock P/E ratios has reduced, but not completely removed, the multiple risk.

We believe the major threat to earnings in the short term is the prospect of an economic slowdown as central banks continue to attempt to counter inflation through higher rates. The pace may differ by region. Longer term, there could be further pressures on earnings, such as the need to build more resilient supply chains or potentially higher corporate tax rates as governments look to repair their finances.

Given the uncertain macroeconomic landscape and the room for policy errors, we continue to advocate for a portfolio of high-quality compounders. The combination of these companies' recurring revenues and pricing power should protect revenues and margins in a downturn, providing asset owners with earnings resilience and relative predictability through tougher, more volatile times.

William Lock
Head of International Equity

Bruno Paulson
Portfolio Manager
International Equity

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

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EV Forward

"Investing in companies with true pricing power is crucial because earnings should be relatively resilient in a squeeze on the wider market's profitability."

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