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Equity Opportunities After Easy Money

If you invested in a market capitalization-weighted global equity index strategy over the decade to 2021, you did very well indeed.

For the most part, however, that was due to an extraordinary run of performance by U.S. large cap growth, itself largely driven by a handful of mega-cap U.S. technology stocks linked to the rise of smartphones, social media, cloud computing—and rock-bottom interest rates.

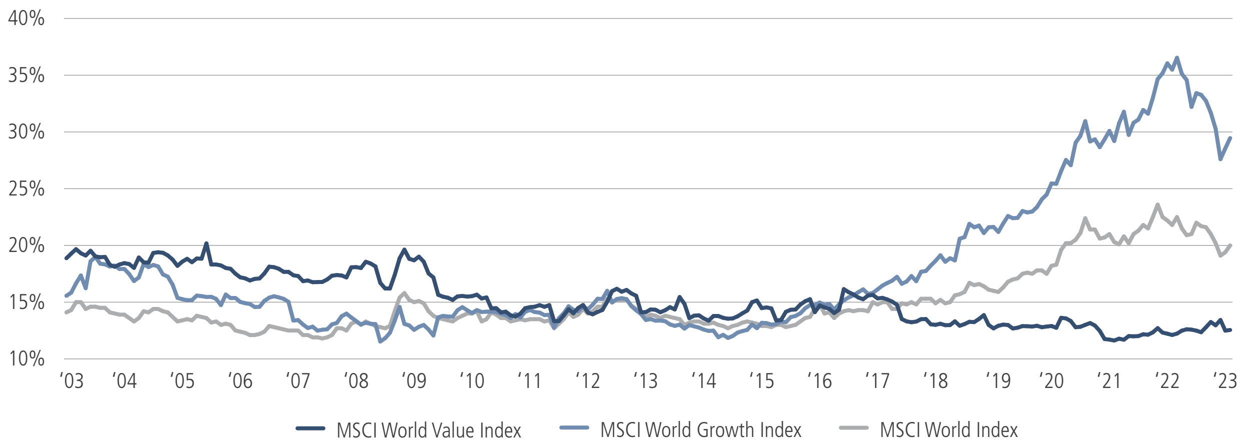
However, if you were still market-cap weighted through 2022, when rising inflation, tighter monetary policy and petering growth crashed the party, you gave a good portion of those gains back.

We believe we've entered a new economic regime marked by higher rates and resurgent economic volatility—a fundamental reversal that, in our view, calls for more thoughtful and selective portfolio positioning. In this article, we discuss four major unfolding trends that we think present attractive equity opportunities in the era after easy money.

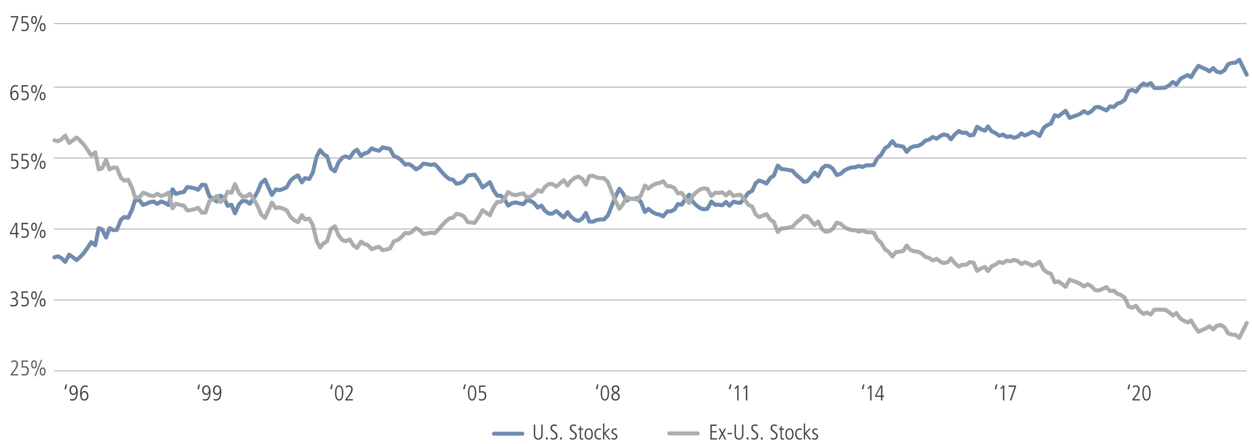
Figure 1 shows how the outperformance of U.S. large-cap growth stocks, particularly since 2015, has "distorted" the so-called broad MSCI World Index. The Index has become more and more concentrated in fewer and fewer stocks, and those stocks have tended to be large U.S. growth stocks.

FIGURE 1. MARKET CAPITALIZATION INDICES HAVE GROWN MORE CONCENTRATED IN U.S. LARGE-CAP GROWTH STOCKS

Proportion of index market capitalization accounted for by the top percentile of stocks by size



Proportion of MSCI World Index market capitalization accounted for by U.S. and ex-U.S. stocks



Source: MSCI, FactSet, Neuberger Berman. Data as of February 27, 2023. Information on historical observations about markets, asset or sub-asset classes is not intended to represent or predict future events. Historical trends do not imply, forecast or guarantee future results. **Past performance is no guarantee of future results.**

We believe the tide has turned. The performance shown in the top chart suggests it turned in 2022, and we think this is due to a structural change in economic fundamentals: the return of higher inflation, higher rates and potentially more volatile business cycles.

In our view, this calls for more thoughtful and selective portfolio positioning than the regime that persisted for the past decade or so, when passive market-cap investing captured much of the upswing in the U.S. large-cap growth factor. Specifically, we identify four major unfolding opportunities:

- **The flight toward *even better* earnings quality.** Over the last six decades, companies with lower operating margins tended to underperform their more profitable peers; likewise, companies that relied on more aggressive accounting techniques suffered relative to their conservative competitors. We believe extra aggression is likely to earn extra punishment in both the current downturn and over the longer horizon.
- **Cheaper companies over growth stories.** Value stocks outpaced high-flyers for eight decades until easy money flipped the script. We believe higher domestic inflation and a potentially weakening U.S. dollar (now at historic highs) will likely usher in a period of global reflation which, in the past, has often benefitted value stocks.
- **Smaller companies over large players.** Similar to the long-term value-versus-growth trend, small caps typically edged out large caps before the 2008 financial crisis. In our view, historical valuation differentials and dollar cycles now imply that small caps are ready for a revival.
- **Non-U.S. over U.S.** As the dollar weakens, non-U.S. developed markets (as well as emerging ones) could be set to outperform.

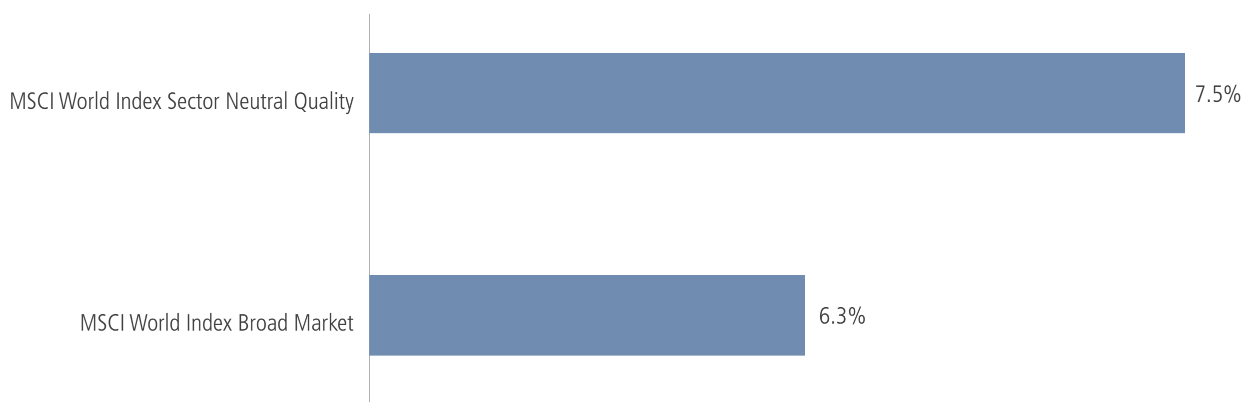
We explore each of these four trends in the following sections. And for a quicker, graphical representation of the first three, please see the chart included in the **Appendix**.

Earnings Quality Matters Even More Now

As Eugene Fama and Kenneth French firmly established, quality always matters—and it starts with operating profitability.

Over the last 60 years, higher-quality companies—meaning those with higher operating margins as a proportion of book equity—have outperformed lower-quality companies by 1.2 percentage points per year (figure 2).

FIGURE 2. HIGHER QUALITY HAS OUTPERFORMED OVER THE LONG TERM
Annualized return, 1963 – 2022



Source: Bloomberg, Kenneth French data library. Analysis period from June 1963 to October 2022. Higher quality is defined as higher operating margins as a proportion of book equity, or (sales – (cost of goods sold + SG&A + interest expense))/book equity.

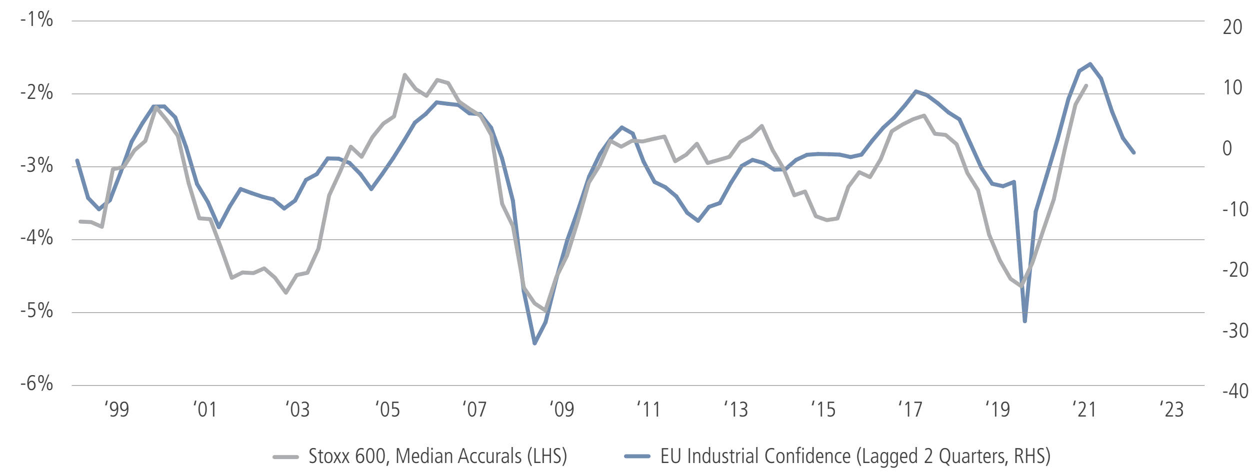
But the hunt for quality doesn't end here.

Aggressive use of accounting accruals—which essentially represent best-case financial assumptions and create disconnects between reported net income and actual cash flow—can lend a rosy hue to a company's reported numbers, thus calling their quality into question. It tends to proliferate as corporate optimism swells—a late-cycle development seen in the late-1990s mid-2000s and now.

Currently, the use of accruals in the U.S. is as widespread as it has been in the last 30 years, and in Europe it is more widespread than at any time since 2007 (figure 3). We have shown the business cycle in the form of the Purchasing Managers' Index (PMI) and Industrial Confidence survey because we believe aggressive accounting matters even more during economic downturns, when accruals can quickly translate into write-offs, hammering equity returns. We think companies that lean heavily on accruals could be hit disproportionately in the ongoing earnings-driven phase of the current downturn.

FIGURE 3. CORPORATE EARNINGS QUALITY AT MULTI-YEAR LOWS

Level of accrued earnings versus business cycle indicators, U.S. and Europe



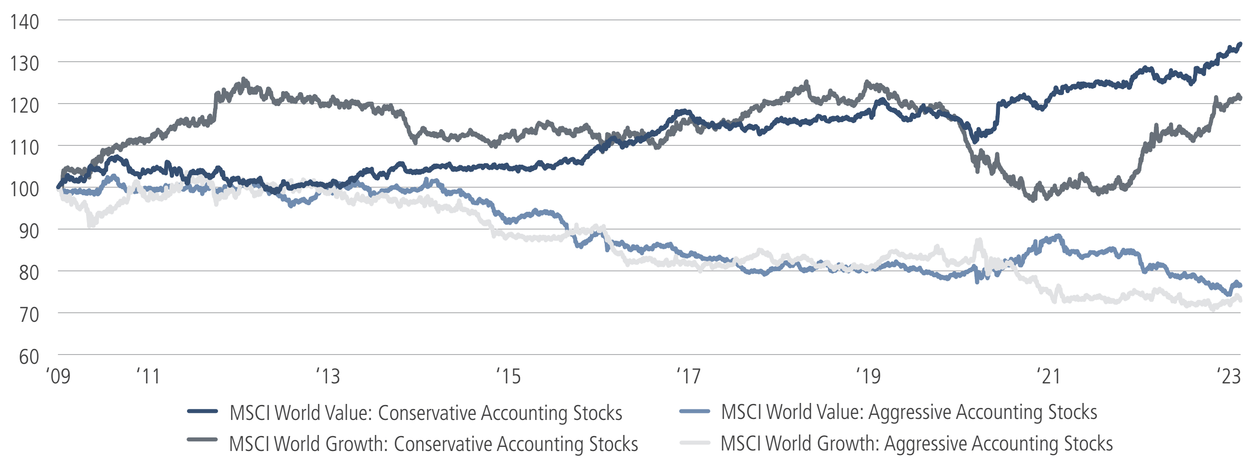
Source: FactSet, Piper Sandler, Neuberger Berman. Data as of December 31, 2022. Accruals are defined as (net income – operating cash flow)/assets.

Figure 4 captures the damage wrought by aggressive accounting over time. Since 2010, companies with relatively conservative accounting in the MSCI World Growth Index have outperformed the broad Growth Index by 2.9 percentage points per year, while conservative companies in the MSCI World Value Index have outperformed the broad Value Index by almost 3.8 percentage points per year. Value stocks that tend to use more accruals are more likely to turn out to be "value traps"—they trade at apparently low multiples, but those multiples may be a true reflection of their real earnings. Growth stocks using more accruals are simply less likely to realize their promised earnings growth.

We expect the performance gap shown in figure 4 to widen—for both value and growth stocks—as slowing growth meets historically elevated accruals during the anticipated recession and over the potentially more volatile economic cycles that we think we face over the longer term.

FIGURE 4. LOW EARNINGS QUALITY CAN SIGNAL A VALUE TRAP OR A GROWTH DISAPPOINTMENT

Relative Performance, MSCI World stocks with aggressive accruals versus conservative accruals



Source: MSCI, FactSet, Piper Sandler, Neuberger Berman. Data as of December 31, 2022. Aggressive Accounting Stocks are in the top quintile of their Index in terms of levels of accrued earnings and Conservative Accounting Stocks are in the bottom quintile; all four portfolios are equally weighted. Information on historical observations about markets, asset or sub-asset classes is not intended to represent or predict future events. Historical trends do not imply, forecast or guarantee future results. **Past performance is no guarantee of future results.**

Ben Graham Strikes Back

Once upon a time, the idea was to "buy low and sell high." Yet with the equity markets awash in cheap money following the 2008 financial crisis, that mantra gradually morphed into "buy high and sell higher."

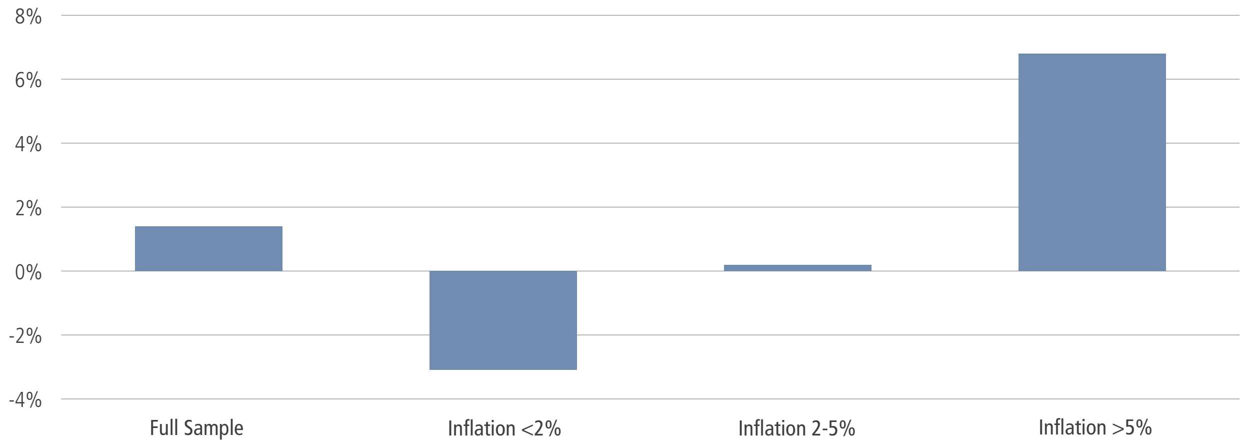
Though a younger generation of asset managers may find it hard to fathom, value stocks used to be, indeed, valuable. Looking at U.S. stocks, where we have a long history of performance data from Bloomberg and the Kenneth French data library, value stocks outperformed growth companies by three percentage points a year, on average, with only brief periods of exception, until 2008. But when the U.S. Federal Reserve (Fed) slashed interest rates to revive the economy, the equity market—especially growth stocks—went on a tear: From December 31, 2008, to October 31, 2022, growth trounced value by 3.2 percentage points per year. Benjamin Graham—long-revered "father of value investing"—would have been at wit's end.

We believe this recent period was, in certain respects, a Fed-fomented anomaly.

In our view, that extended period of highly accommodative monetary policy, when it met the extraordinary post-COVID fiscal stimulus, led to a final push lower for global risk premia, turbocharged growth stocks and, ultimately, unleashed inflation. And when inflation has struck in the past, value has tended to trump growth to an even greater degree than normal: Since the mid-1970s, when U.S. inflation has been north of 5%, MSCI World Value has outperformed Growth by 6.8 percentage points, on average (figure 5).

FIGURE 5. VALUE HAS TENDED TO OUTPERFORM DURING INFLATIONARY PERIODS

Average one-year trailing outperformance, MSCI World Value Index over Growth Index, 1974 - 2023



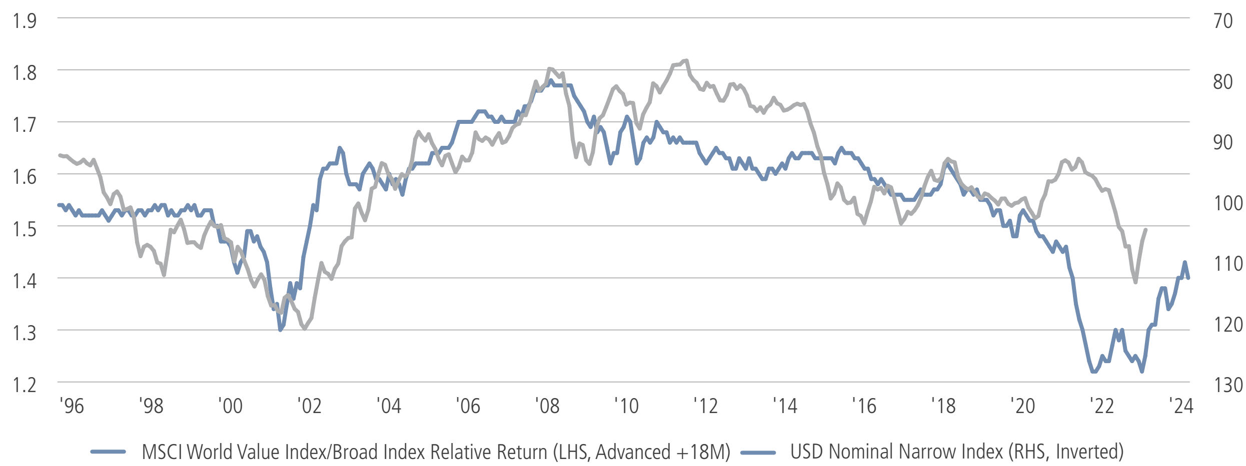
Source: MSCI, Bureau of Labor Statistics, FactSet, Neuberger Berman. Analysis period from January 1974 to January 2023. Inflation is year-over-year growth in the U.S. Consumer Price Index. Information on historical observations about markets, asset or sub-asset classes is not intended to represent or predict future events. Historical trends do not imply, forecast or guarantee future results. **Past performance is no guarantee of future results.**

This trend stands to intuition. First, higher inflation often comes with higher interest rates. Growth stocks are more sensitive to higher rates than value stocks because growth companies tend to generate more of their earnings in the future—and discounting those future earnings at higher rates lowers their present value. Also, value stocks tend to include many financial services firms, which can outperform when rates rise.

Could inflation cool over the next 12 months? Perhaps—yet we believe the economy has entered a new regime marked by historically higher structural inflation that tends to bode more favorably for value strategies over the long term.

We have also found that the U.S. dollar can offer useful clues about value stocks' potential outperformance. Figure 6 highlights the negative relationship between the dollar and the relative performance of the MSCI World Value Index over the broad Index since the mid-1990s. As the dollar has risen, value has tended to underperform, and vice versa. Value stocks started to lose ground to growth stocks around 18 months before the 2008 peak in world currencies' strength against the dollar and, especially after 2011, value stocks' underperformance continued to anticipate dollar outperformance by 18 months.

FIGURE 6. VALUE STOCKS' OUTPERFORMANCE AND U.S. DOLLAR CYCLES



Source: FactSet, Neuberger Berman. Data as of February 27, 2023. Information on historical observations about markets, asset or sub-asset classes is not intended to represent or predict future events. Historical trends do not imply, forecast or guarantee future result**s. Past performance is no guarantee of future results.**

Dollar cycles tend to last seven to 10 years, implying that a tide that is ready to turn, in our view. Should we see evidence of sustained weakening of the dollar through 2023, that would raise our confidence that the value outperformance that began last year has potential to last.

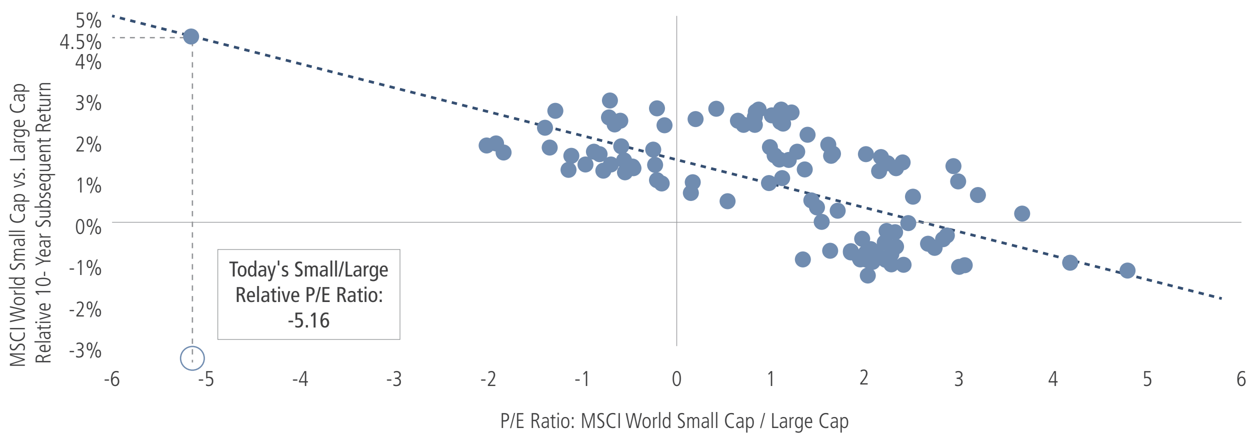
Small Caps May Regain Their Historic Edge

Mighty returns often come in small packages—or at least they used to. Similar to value performance over growth, for eight decades before the 2008 crisis, small-cap stocks tended to outperform large-caps, but the script has flipped since then.

We credit that shift, in part, to the emergence of "Big Tech" and its relative dominance within market-cap-weighted indexes. In the new economic regime, however, we think history will have its due.

First, consider the relative valuations of the two groups, as shown in figure 7. At current levels, the price-to-earnings (P/E) ratio of the MSCI World Small Cap Index is more than five points lower than the P/E of the Large Cap Index. When we plot that differential against the indexes' subsequent 10-year returns, since 2004, and extrapolate the trendline that best fits the relationship between those two datasets, it suggests that small caps could outperform large caps by four or five percentage points over the coming decade. (It should be noted that this is, for the most part, reflective of the extreme relative overvaluation of U.S. large caps in the MSCI World Index; when we plot the same chart for the MSCI EAFE Small Cap and Large Cap Indices, there is no period when large caps are as extremely overvalued, and the relationship between the datasets is not so strongly linear.)

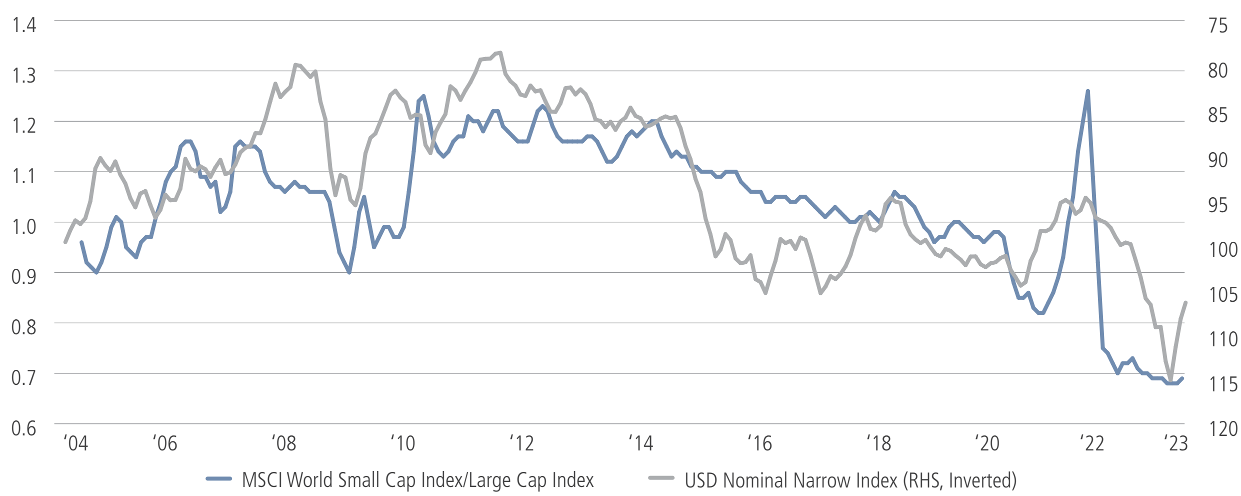
FIGURE 7. RELATIVE VALUATION OF SMALL VERSUS LARGE CAPS HAS ANTICIPATED RELATIVE PERFORMANCE



Source: MSCI, Bloomberg, FactSet, Neuberger Berman. Analysis period from June 2004 to January 2023. Information on historical observations about markets, asset or sub-asset classes is not intended to represent or predict future events. Historical trends do not imply, forecast or guarantee future results. **Past performance is no guarantee of future results.**

Second, any sign of weakness in the U.S. dollar could again send hopeful signals, for small caps as well as value stocks. As figure 8 shows, small-cap outperformance has tended to track dollar weakness.

FIGURE 8. SMALL CAP OUTPERFORMANCE AND U.S. DOLLAR CYCLES



Source: Bloomberg, MSCI, FactSet. Data as of January 31, 2023. Information on historical observations about markets, asset or sub-asset classes is not intended to represent or predict future events. Historical trends do not imply, forecast or guarantee future results. **Past performance is no guarantee of future results.**

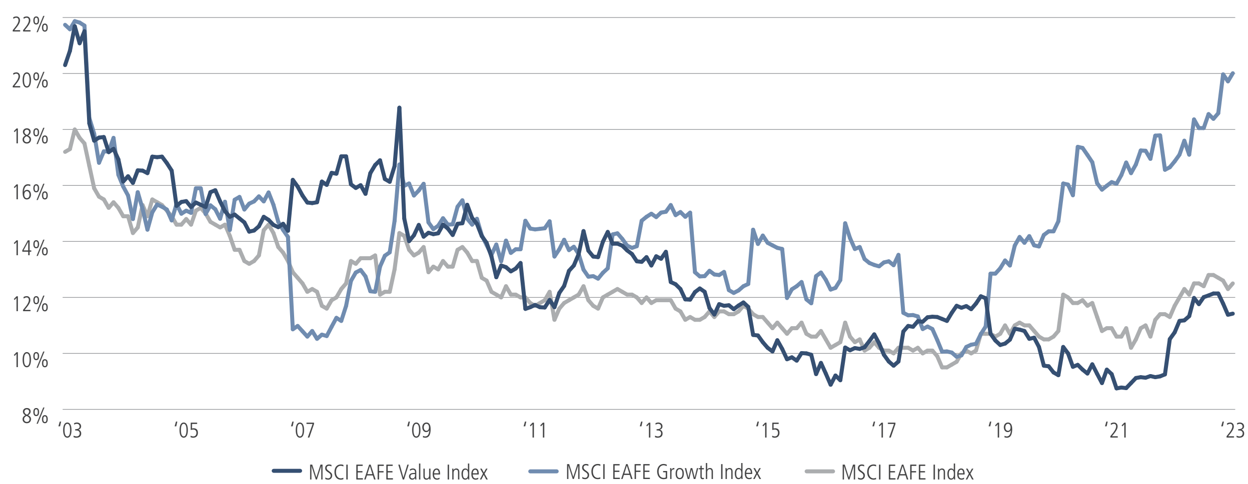
Non-U.S. Markets Offer Inviting Shores

At this point, it's worth taking you all the way back to figure 1, which showed just how dominant U.S. large-cap growth stocks had become in the MSCI World Index of developed-market stocks. This was a function of growth stocks coming to dominate the U.S. market, and the increasingly growthy U.S. market consequently coming to dominate world market capitalization.

Move outside the U.S., however, and while growth stocks have certainly outperformed substantially over the past few years, they have not become dominant in broad market indices in the same way (figure 9). The reason is straightforward: the concentration effect in the U.S. market has been due to its unique collection of not merely large-cap growth stocks, but mega-cap growth stocks—the infamous "FAANGs."

FIGURE 9. OUTSIDE THE U.S., GROWTH OUTPERFORMANCE HAS NOT LED TO BROAD INDEX CONCENTRATION

Proportion of index market capitalization accounted for by the top percentile of stocks by size



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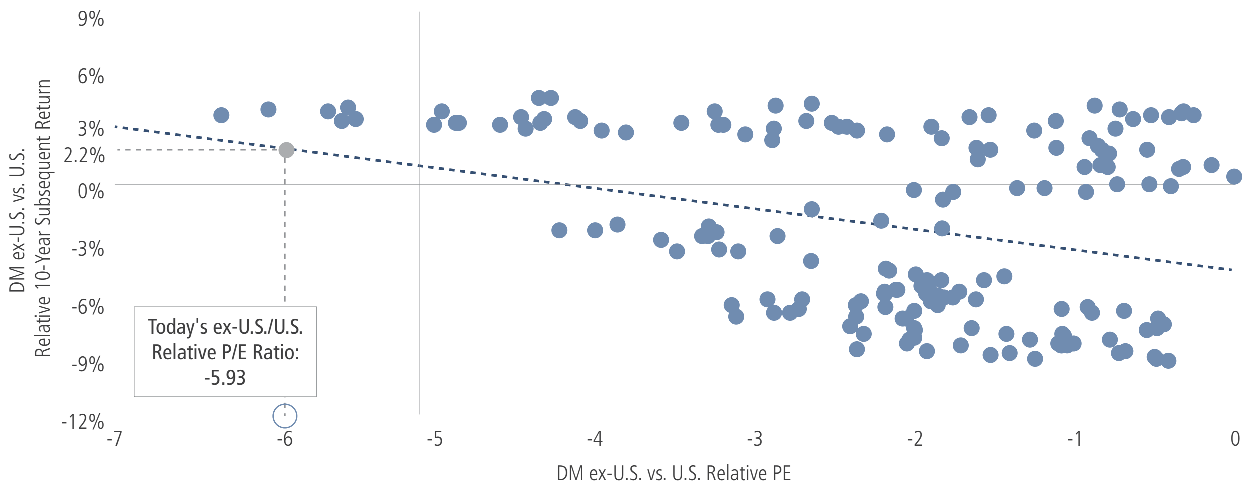
As a result, investing in passive market capitalization-weighted strategies outside the U.S. does not carry the same risk of exposure to the mega-cap growth factors as it does within the U.S., in our view.

And we think there are other reasons to favor ex-U.S. markets at the moment. Just as relative valuations and dollar-cycle relationships support a case for both value stocks and small caps (even when these include U.S. stocks), they also appear to support a case for ex-U.S. stocks.

Start with valuation. Since 1970, the U.S. market has outperformed ex-U.S. developed markets (DMs) by 1.3 percentage points per year, on average, according to MSCI data, but most of that gap has appeared since 2014—and it has resulted in relative valuations that now appear to favor the ex-U.S. markets.

When we plot the MSCI USA and MSCI EAFE valuation differential against the indexes' subsequent 10-year returns, since 1995, we see a less linear relationship than we saw with small caps versus large caps; nonetheless, when we extrapolate the trendline that best fits this relationship, it suggests that ex-U.S. DMs could outperform the U.S. market by two to four percentage points over the coming decade.

FIGURE 10. RELATIVE VALUATION OF U.S. VERSUS EX-U.S. MARKETS HAS ANTICIPATED RELATIVE PERFORMANCE

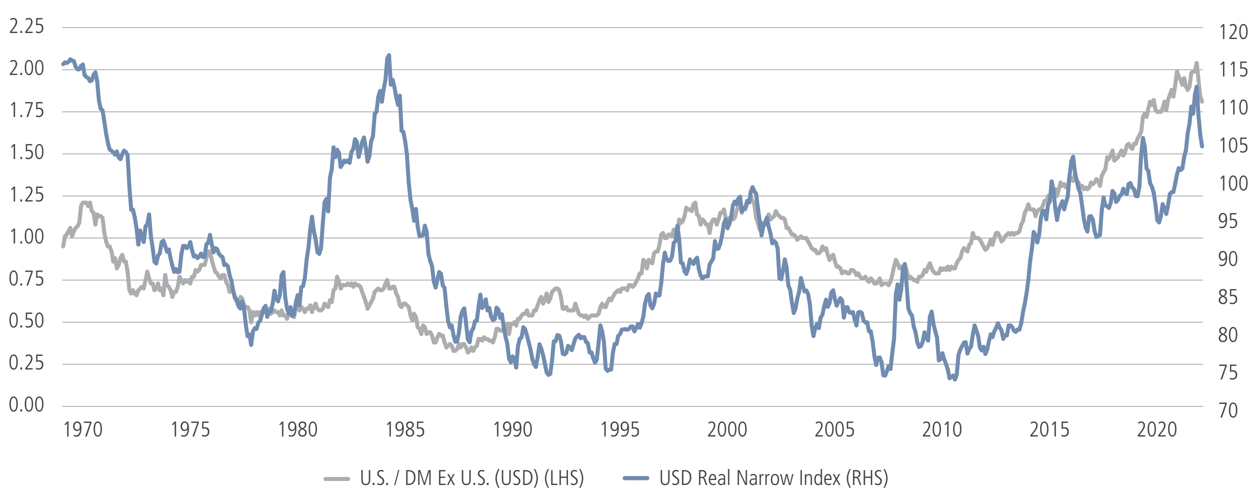


Source: MSCI, FactSet, Neuberger Berman. Indices used are MSCI USA and MSCI EAFE, Gross returns. Analysis period from January 1995 to November 2022. Information on historical observations about markets, asset or sub-asset classes is not intended to represent or predict future events. Historical trends do not imply, forecast or guarantee future results. **Past performance is no guarantee of future results.**

MSCI data over the same period suggest that the current valuation differential between the MSCI Emerging Markets Index and the MSCI World Index would, historically, have been followed by an average of around six percentage points of outperformance by the emerging markets over the subsequent 10 years.

We also believe that a falling dollar should favor non-U.S. allocations. Figure 11 shows how the relative performance of ex-U.S. DMs versus the U.S. market has tracked the dollar since 1970, with the ex-U.S. markets tending to outperform when the dollar is weakening.

FIGURE 11. U.S. OUTPERFORMANCE AND U.S. DOLLAR CYCLES



Source: MSCI, FactSet, Neuberger Berman. Indices used are MSCI USA and MSCI EAFE, Gross returns. Data as of November 30, 2022. Information on historical observations about markets, asset or sub-asset classes is not intended to represent or predict future events. Historical trends do not imply, forecast or guarantee future results **Past performance is no guarantee of future results.**

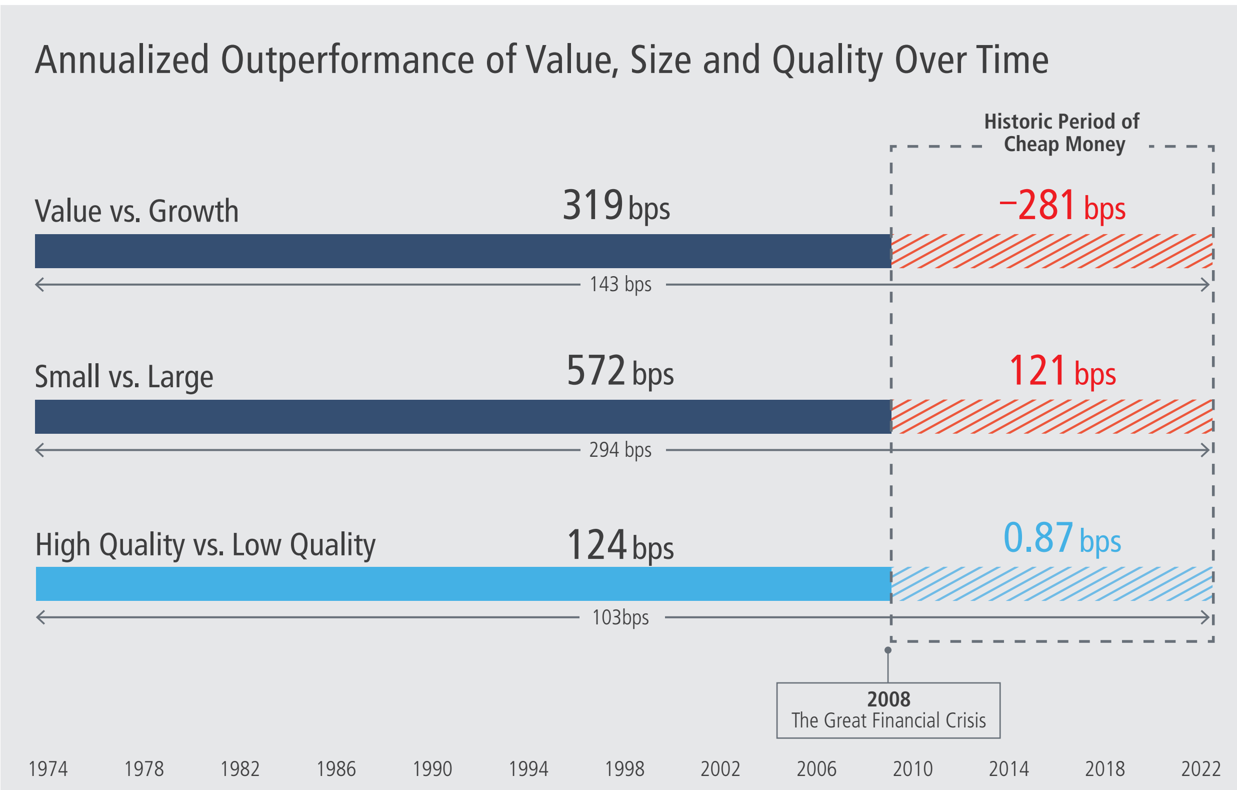
This relationship might come as little surprise: as figure 9 suggests, the sectoral composition of broad DM-ex-U.S. indices tends to align more closely with value than growth, with more industrial and banking stocks rather than technology companies, for example. In essence, ex-U.S. DM versus U.S. can be thought of as value vs. growth playing out on the global stage.

Conclusion

The last decade or so is sometimes characterized as a golden age for equities. In fact, it was a golden age for an increasingly narrow slice of the equity market: large- and mega-cap U.S. growth stocks. This translated into high returns to passive U.S. and world equity index strategies only because those mega-cap U.S. growth stocks accounted for a bigger and bigger share of those indices.

We believe that phenomenon owes a lot to the environment of artificially low inflation, interest rates and business-cycle volatility that prevailed between the Global Financial Crisis and 2022—and that the tide has now turned. In our view, this calls for more thoughtful and selective portfolio positioning, which favors smaller stocks, is more regionally balanced, and pays more attention to both valuations and quality of earnings. It should also lead to greater dispersion in stock performance than we have seen over recent years, creating more opportunity for active managers to outperform market-capitalization benchmarks.

Appendix



INDEX DEFINITIONS

The **MSCI World Index** tracks the performance of large- and mid-cap stocks across 23 developed markets countries.

The **MSCI World Value Index** tracks the performance of large- and mid-cap stocks across 23 developed markets countries that exhibit overall value style characteristics.

The **MSCI World Growth Index** tracks the performance of large- and mid-cap stocks across 23 developed markets countries that exhibit overall growth style characteristics.

The **MSCI World Sector Neutral Quality Index** tracks the performance of large- and mid-cap stocks across 23 developed markets countries that exhibit high return on equity, low leverage and low earnings variability relative to their peers within the same sector.

The **MSCI World Large Cap Index** tracks the performance of large-cap stocks across 23 developed markets countries.

The **MSCI World Small Cap Index** tracks the performance of small-cap stocks across 23 developed markets countries.

The **S&P 500 Index** consists of 500 U.S. stocks chosen for market size, liquidity and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value.

The **STOXX Europe 600 Index** is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the Index represents large, mid and small capitalization companies across 17 countries of the European region: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

The **MSCI EAFE Index** tracks the performance of large- and mid-cap stocks across 21 developed markets countries in Europe, Australasia and the Far East, excluding the U.S. and Canada.

The **MSCI EAFE Value Index** tracks the performance of large- and mid-cap stocks across 21 developed markets countries in Europe, Australasia and the Far East, excluding the U.S. and Canada that exhibit overall value style characteristics.

The **MSCI EAFE Growth Index** tracks the performance of large- and mid-cap stocks across 21 developed markets countries in Europe, Australasia and the Far East, excluding the U.S. and Canada that exhibit overall growth style characteristics.

The **MSCI USA Index** tracks the performance of large- and mid-cap stocks in the U.S.

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