SUNRISE ON VENUS

PREPARING FOR THE INVESTING ENVIRONMENT OF THE NEXT DECADE

This document is intended for wholesale investors. Capital at risk.

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INTRODUCTION

Venus goes 117 days, or nearly four months, between sunrise and sunset. With days so long, it's easy to imagine growing used to day or night, rather than thinking of the next sunset. We've been through something similar in the investing world. Growth and passive strategies have enjoyed a long day in the sun, but investors have grown too complacent about them, positioned as if the sun will never set. With valuations and positioning where they are, that makes the coming sunset dangerous.

Investors can prepare for sunrise by getting properly diversified, across economic exposures and across styles within equities. Fortunately for active investors, there are thousands of opportunities to choose from, and we've found many diversifying shares that are trading at a discount.

Using long-term data, this paper looks at how we got here, which equities are at risk, why the investing world is changing, and how investors can prepare for the decade ahead. With the right active strategies, investors can look forward to sunrise, rather than fearing sunset.

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1

SUNSET FOR GROWTH AND PASSIVE STRATEGIES

THE WORLD IS TURNING FROM HELPFUL TO HOSTILE FOR THE WINNERS OF THE LAST DECADE

- STOCKMARKETS HAVE PERFORMED FABULOUSLY WELL
- BROAD STOCKMARKETS ARE ONCE AGAIN EXPENSIVE
- WITHIN STOCKMARKETS, GROWTH SHARES ARE EXCEPTIONALLY EXPENSIVE

The last decade was a fabulous time to own financial assets. Globalisation thrived and worker power waned, allowing higher corporate profits, a boon to owners in equities. A rush of capital chased gushers of shale oil and gas, flooding the global economy with cheap fuel. And as the West recoiled from shows of military muscle, governments diverted funds from defence to domestic uses.

Crucially, those forces also reduced inflation. With inflation a fading memory, central banks[1] felt safe in cutting interest rates at any hint of economic or financial pain. So they did, fighting every crisis and slowdown with ever-declining interest rates and ever-greater money printing. These too were a boon to investors. Low inflation, subterranean interest rates, and central bank bond purchases all pushed bond yields to the lowest levels in recorded history. Record-low bond yields the returns required of equities, so equity valuations swelled, and valuations of exciting growth businesses ballooned the most. With bond yields falling in response to every economic wobble, stocks and bonds enjoyed a happy marriage. Over short periods, bonds reliably counterbalanced stocks. Over the full period, they both went up. A lot.

[1]The institutions may have behaved like inflation was a historical myth, but for individuals, those memories don't fade. Indeed, one of the best predictors of whether a Federal Reserve policymaker will be an inflation-fighting "hawk" or an inflation-relaxed "dove" is simply whether inflation was high when they were growing up.

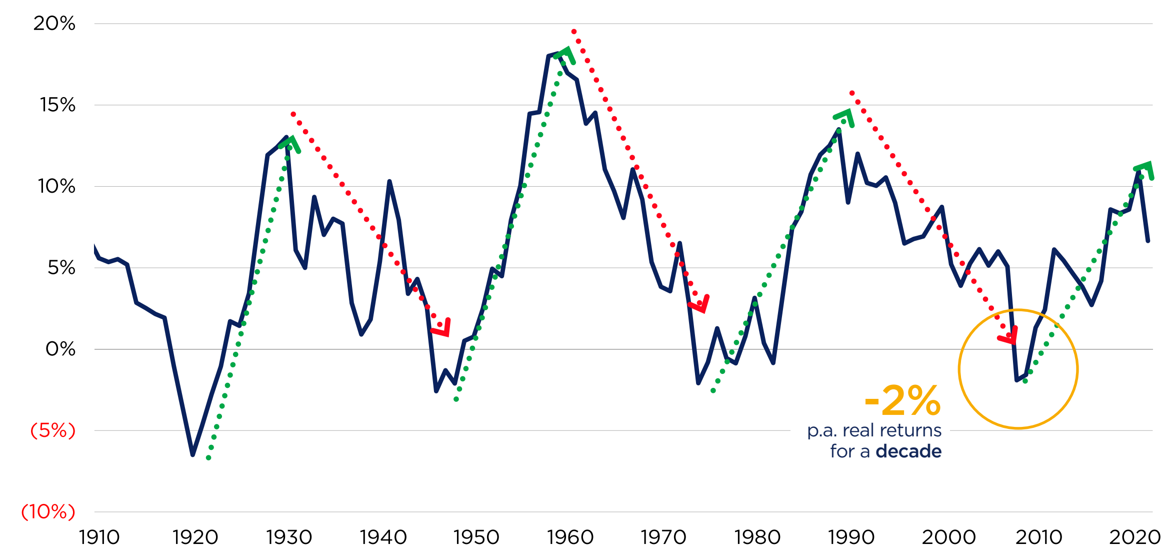
A LONG DAY IN THE SUN

Figure 1 shows what an enjoyable ride it was. An investor in 2011 received an 11% p.a. real return (in USD) on global equities for the next ten years. Their purchasing power nearly tripled. The chart shows that such high returns are rare. The only better times in history to buy equities all ended near the peaks of major bubbles, including the great crash of 1929, the Japan bubble of 1990, and the original Tech bubble of 2000. The chart takes the shape of a sawtooth. Long periods of great returns give way to long periods of poor returns.

In markets as on Venus, the days can be long and sunny. But night does come, and the nights can be long and dark.

FIGURE 1. PERIODS OF GREAT RETURNS TEND TO BE FOLLOWED BY PERIODS OF POOR RETURNS

Rolling 10-year inflation-adjusted returns for global equities (USD, annualised)



31 Dec 2022 | Source: Dimson, Marsh and Staunton, Refinitiv, MSCI, Orbis. Data for global equities is from the Dimson, Marsh and Staunton (DMS) database prior to 2010, and for the MSCI World Index after that date. Returns prior to 2010 are calculated for 16 size-weighted developed markets. The weights are based on GDP weights prior to 1968, and MSCI country capitalisations after that date. All returns are calculated in US dollars and adjusted for US inflation.

SUCH **HIGH RETURNS** ARE RARE...THE ONLY BETTER TIMES IN HISTORY ALL ENDED NEAR THE PEAKS OF **MAJOR BUBBLES**.

VALUATIONS FOR BROAD GLOBAL STOCKMARKETS ARE ONCE AGAIN EXPENSIVE

The nights are darkest when prices are high at sunset. By looking at a range of long-term valuation measures, we can form a better idea of the returns we should expect in the years ahead.

Using a range of measures is important, as metrics come in and out of vogue. We always care about free cash flow per share, but tastes change. In its 2019 initial public offering, Uber claimed it should be valued against its total addressable market, which it defined as all personal mobility, all restaurant spending, and all freight trucking—a smooth $12.3 trillion. Nevermind whether it could profitably address those markets. Later that year, they urged a more plausible focus on gross bookings and active users. A year later, their CEO finally mentioned revenues in his opening earnings call remarks. By 2021, they deigned to focus on earnings—excluding interest, tax, depreciation, amortisation, and several other key expenses. It wasn't until the end of 2022, after a bruising share price crash, that they committed to generating positive free cash flow.

Looking over the long term is even more important. Five years feels long, but could be just half a business cycle. If you looked at five years of bank history in 2007, you'd see a consistent record of swaggering high-return profit-growth. Ten years is long, but short enough to be swayed by a single trend. Through the whole 1980s, it seemed that Japan would take over the world and all the markets in it. Even 20 years of data may be insufficient to capture the full range of likely outcomes. Until recently, it had been over 20 years since anyone in the rich world experienced high inflation.

In Figure 2a, we have pulled together a dozen valuation measures, stretching as far back as possible using commercial, academic, and our own proprietary data sets. While we've plotted the chart from 1970, the history for a handful of US measures goes all the way to 1900. To show very different measures on a single chart, we've represented each of them as a percentile. If a line is at 70%, it means that stockmarkets have been cheaper 70% of the time over the whole history for that metric.

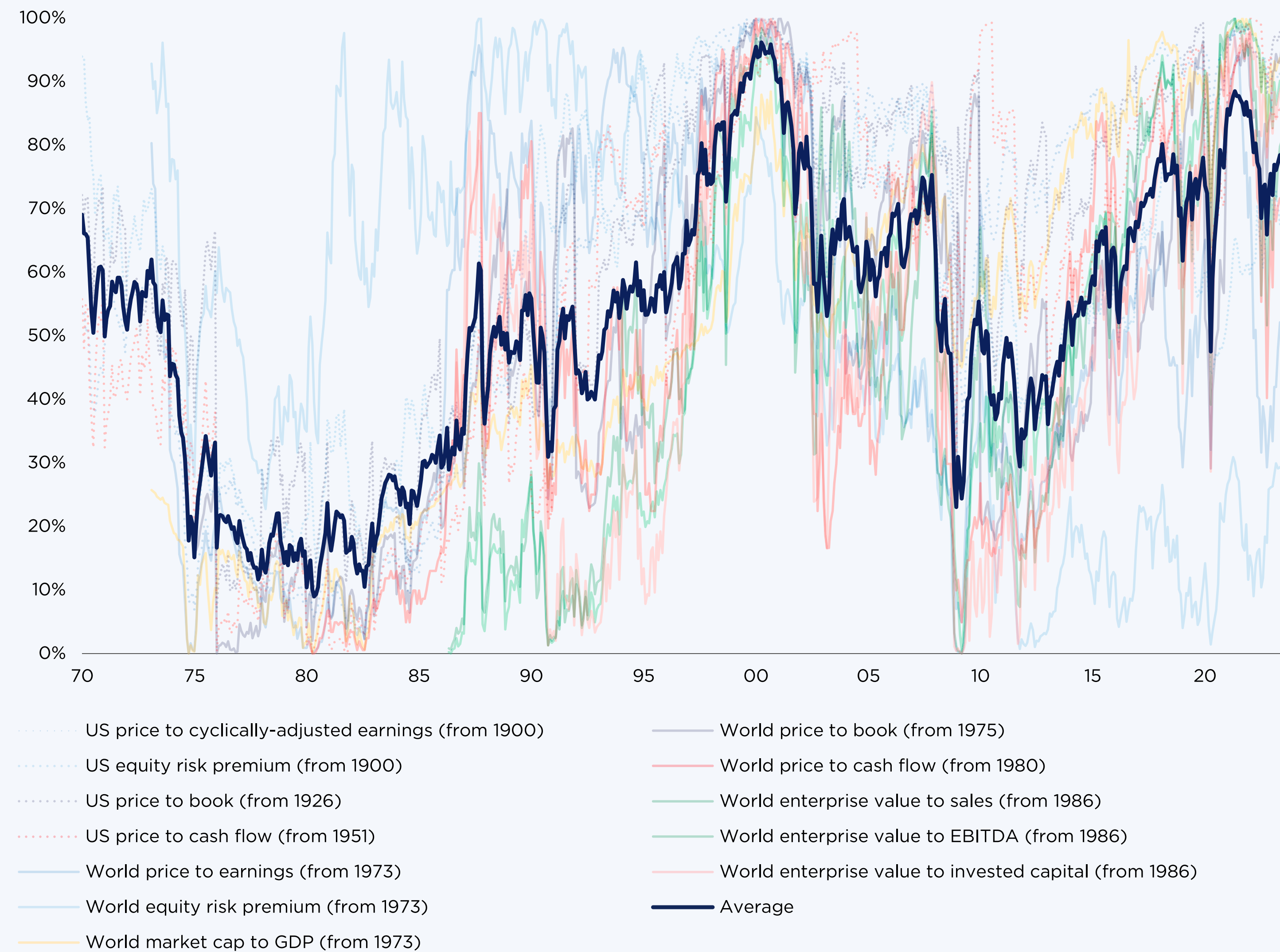
Usually, the range of metrics gives a range of signals. When profits are down, price-earnings ratios look expensive, while price-to-book and price-to-sales ratios look cheap. When profit margins are high, earnings measures look reasonable, while sales measures look rich. When companies pile on debt, enterprise value multiples look worse. And so on.

If you stand back and squint, the chart is a mess. Or, mostly a mess. The lines do converge at the peaks and troughs of greed and fear. In 1980, almost every ratio suggested that stockmarkets were attractive, and in 2000 and 2021, almost every measure suggested that markets were in a bubble.

Worryingly, the picture doesn't look too different today. If we take the average of the dozen measures, stockmarkets today are priced in the 84th percentile. On an average of these measures, stockmarkets have been cheaper 84% of the time, and have only been more expensive 16% of the time. That does not bode well for the future returns of equities as an asset class–or for passive equity strategies.

FIGURE 2A. GRAND UNIFIED CHART OF US AND GLOBAL STOCKMARKET VALUATIONS

Stockmarket valuation percentile for 12 long-term measures, plotted from 1970



31 Jul 2023 | Source: Robert Shiller, Kenneth French, World Bank, Refinitiv, Worldscope, Orbis. Percentiles calculated over the full history for each measure. US measures included with dotted lines when they significantly extend the history. Cyclically-adjusted price-earnings ratio uses the average of ten years of inflation-adjusted earnings. US equity risk premium is the cyclically-adjusted earnings to price of equities minus the yield on a 10-year US Treasury note. World equity risk premium is the trailing earnings to price of developed stockmarkets minus a blend of 10-year bond yields for the US (50%), Europe (35%), and Japan (15%). World market cap to GDP calculated using the market capitalisation of developed stockmarkets and the gross domestic product in current USD of high-income countries. Enterprise value measures for developed market non-financial companies. EBITDA is earnings before interest, tax, depreciation, and amortisation.

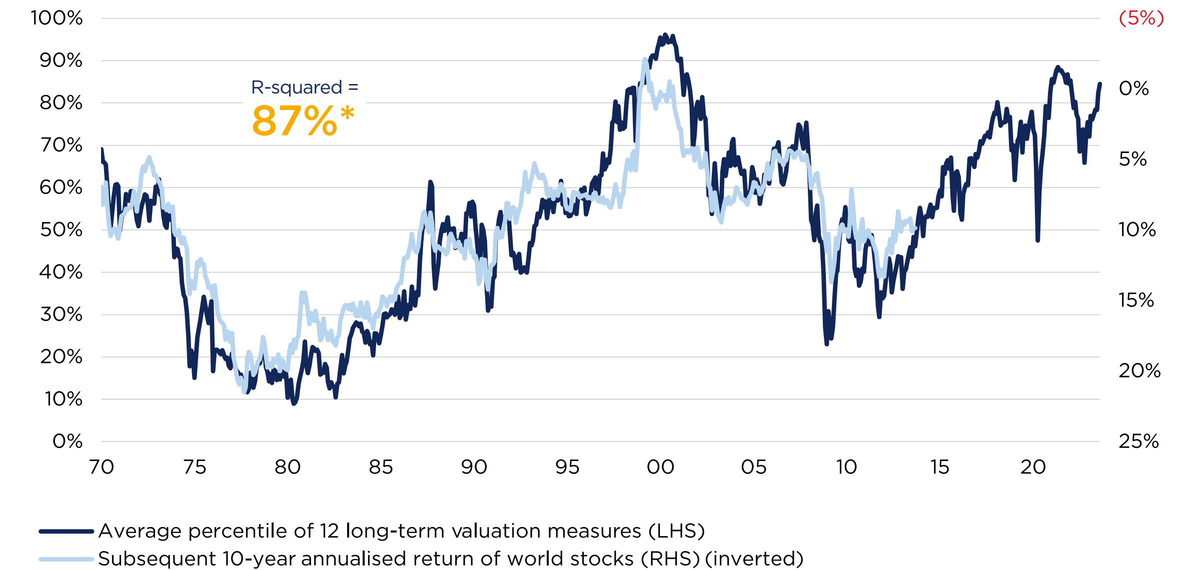
VALUATIONS DRIVE LONG-TERM RETURNS

Valuations are a poor predictor of short-term returns, but they always matter. Over the long term, they are the thing that matters most. This is true for both equities and bonds.

If we return to our chart of long-term stockmarket valuations, we can compare the expensiveness of passive equity exposure to subsequent long-term returns. Figure 2b takes the average of the 12 long-term valuation measures from Figure 2a on a percentile basis. Plotting the subsequent returns of the MSCI World Index shows a very tight link.

FIGURE 2B. EXPENSIVE VALUATIONS SUGGEST POOR SUBSEQUENT RETURNS

Valuation percentile for 12 long-term measures with subsequent 10-year return p.a. of MSCI World Index



31 Jul 2023 | Source: Robert Shiller, Kenneth French, World Bank, Refinitiv, Worldscope, Orbis. Percentiles calculated over the full history for each measure. This Figure 2b takes the average of the 12 long-term valuation measures listed in Figure 2a on a percentile basis. Please refer to footnotes in Figure 2a for further details.

On R-squared, a statistical measure that captures how much variation in one series is "explained" by another, starting valuations explain 87% of variation in subsequent long-term returns[2]. If the relationship is similar to the past, passive investors in global equities could expect a return as low as zero for the next ten years—before inflation. That is not a good starting point for passive equity portfolios.

Taking a long view of historical valuations makes it hard to be enthusiastic about the returns of passive stock market exposure. Now, at dusk, the asset class sitting at the centre of most portfolios seems poised to deliver poor returns. If we are correct, many investors are poised for a long, dark night when the sun finally sets.

[2]This is cheating, a little. The valuation percentile looks over the whole history for each measure, but of course the full range of valuations through 2023 was not known in 1990 or 1980. At this point, however, each of the measures has a long enough history, including bubbles and crashes, that distortions from here should be minor.

THE MOST STRIKING DISPERSION IS WITHIN **STOCKMARKETS**, WHERE GROWTH SHARES REMAIN **EXCEPTIONALLY EXPENSIVE**.

WITHIN STOCKMARKETS, GROWTH SHARES ARE EXCEPTIONALLY EXPENSIVE

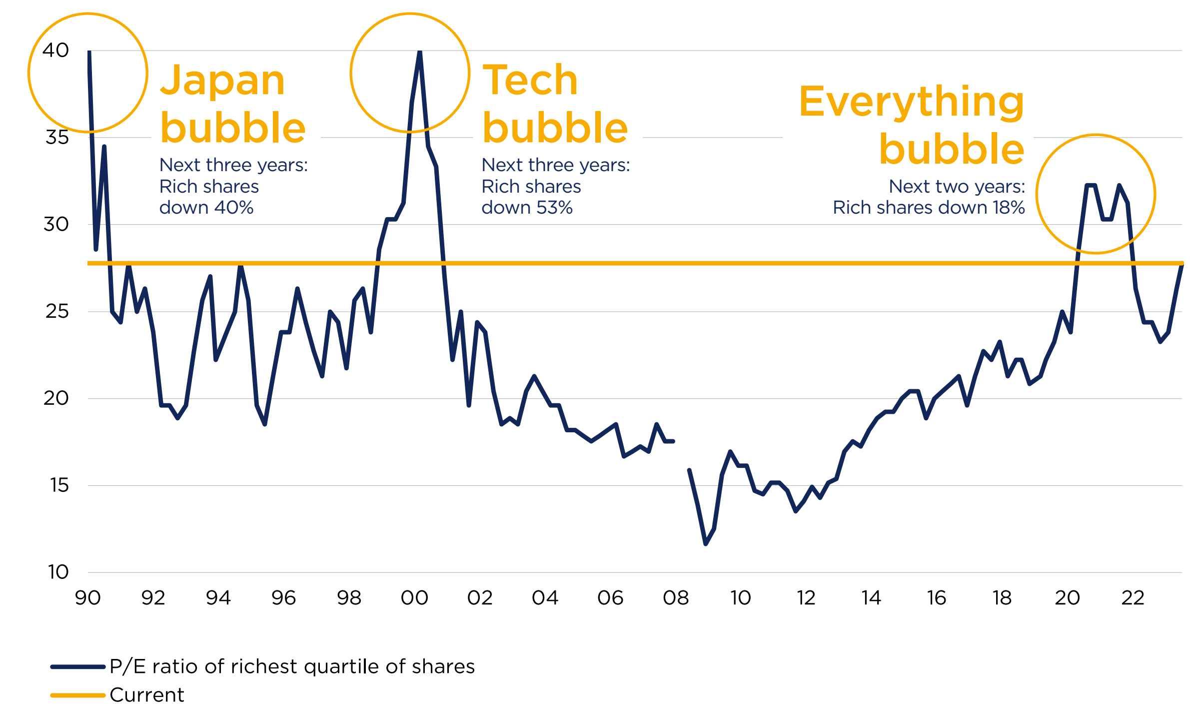
Looking at valuations across whole stockmarket does mask differences within it, however. The most striking dispersion is within stockmarkets, where growth shares remain exceptionally expensive.

In one sense, growth shares are expensive by definition. Academics often define growth as simply "anti-value", with the assumption being that investors paying a high price multiple for a company expect it to grow quickly. But their expensiveness varies.

Today Microsoft is squarely a growth stock[3], but our lucky 2011 investor could have bought it for less than ten times earnings, when Steve Ballmer was still CEO, Microsoft had just launched a phone, Zune media players were still in stores, and Azure was an obscure shade of blue rather than a globally envied cloud juggernaut. Not so today. Microsoft trades at around 30 times expected earnings, and it is not alone. The most richly valued 25% of companies in world stockmarkets trade for an average of 28 times earnings. They have only been more expensive at the peak of the Japan bubble, the peak of the Tech bubble, and the peak of the 2021 "Everything" bubble. As the circles in Figure 3 indicate, that did not end well.

FIGURE 3. GROWTH SHARES HAVE ONLY BEEN MORE RICHLY PRICED AT BUBBLE PEAKS

Forward price/earnings (P/E) ratio of the fundamentally richest quartile of the FTSE World Index



31 Jul 2023 | Source: Worldscope, Orbis. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning. Richest shares are those with the lowest expected returns based on an Orbis proprietary quantitative model.

Having enjoyed a long day in the sun, broad stockmarkets are expensive, which is bad news for passive strategies. And within equities, growth stocks remain exceptionally expensive. Periods of great returns historically give way to periods of poor returns, and those returns are poorest when starting valuations are expensive. They are expensive today, and in the next chapter, we will see the risks of being concentrated in expensive assets.

[3]Unless you ask S&P, which classified it as a value stock at the beginning of this year. S&P's definition of growth includes price momentum, and Microsoft underperformed in 2022. It was a "value" stock trading at 25 times earnings. For the same reason, S&P deemed Exxon, with profit growth of 4% p.a. over the past decade, a "growth" stock. That worked out well for the "value" investors who didn't notice, but we would suggest they get a better grip on what they own.

2

THE DANGERS OF SUNSET

INVESTORS ARE DANGEROUSLY CONCENTRATED IN LAST DECADE'S WINNERS

- PRIOR EXTREMES TOOK A LOT OF PAIN AND A LONG TIME TO UNWIND
- THE WINNERS OF THE LAST DECADE TEND NOT TO PERSIST
- MARKETS ARE CONCENTRATED IN RECENT WINNERS
- INVESTORS ARE CONCENTRATED IN RECENT WINNING STYLES

Sunset on Venus is most dangerous when investors are least prepared for it, and we worry that investors are poorly prepared now.

It is easy to be sympathetic. 2022 was the worst year for stocks since the global financial crisis, and the worst year for bonds in living memory[4]. After the pain of 2022, it is comforting to believe that the hard times are over, and that a boom in artificial intelligence will drive the market higher, with investors rescued by the so-called "magnificent seven" US tech giants. Hope is seductive, but markets can conspire to cause the greatest pain to the greatest number of investors. Today we see scope for potential pain. In our view, investors must adjust either their expectations or their portfolios.

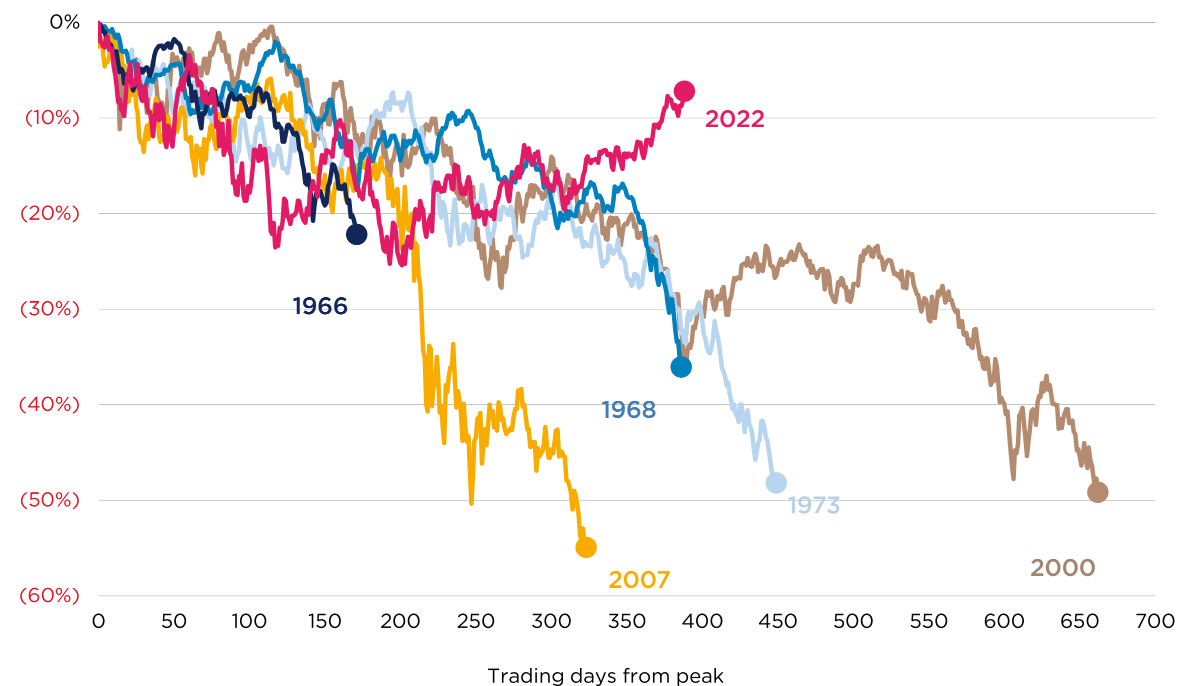
[4]Indeed, in 2022 many of us fielded questions from rattled friends and relatives asking, "how can my bond fund go down?"

PREVIOUS NIGHTS WERE DARKER THAN 2022

For a start, 2022 was not so bad, at least compared to bursts of past historical bubbles.

FIGURE 4. IT USUALLY TAKES MORE PAIN FOR BUBBLES TO UNWIND

Cumulative peak to trough drawdown in the S&P 500 price (USD)



30 June 2023 | Source: Refinitiv.

On the "Buffett indicator" which compares the value of the stockmarket to gross domestic product, the "everything bubble" of 2021 was more extreme than any episode in the last half century. Signs of silliness abounded. In echoes of Dutch tulipmania, "investors" in non-fungible tokens paid millions for the rights to freely-reproducible digital images. Dogecoin, which was created to mock the silliness of Bitcoin, reached a market value of nearly $60 billion.

The stockmarket was not spared its share of speculation. Oceans of free money led to a boom in cash-gushing tech firms, cash-burning tech firms, electric vehicle outfits, and any company with the intoxicating whiff of disruptive innovation. Many of those stories started with a kernel of truth, but as Seth Klarman puts it, "at the root of all financial bubbles is a good idea carried to excess."

Anyone with paper to sell took advantage of that excess. Tesla sold $12 billion, or about one Nissan Motor Company, worth of shares. Whatever the motivations of the offsetting buyers, long-term intrinsic value doesn't seem to have been high on the list—the average Tesla share is bought and sold more than six times a year. 2021 set all-time fundraising records for stocks, corporate bonds, leveraged loans, blank cheque SPACs[5], private equity funds, venture funds, and crypto assets. Financial promoters became celebrities, and celebrities became financial promoters.

Now that money has a cost again, the craziest assets have crashed the hardest, though some have enjoyed a bounce so far this year. In stockmarkets, the experience of last year rhymes with history. When bubbles crash, the most expensive assets fare badly.

[5]Special purpose acquisition companies, which list on stockmarkets and raise cash with the intent to acquire another company.

THE LESSON FROM HISTORY IS THAT PASSIVE EXPOSURE LEADS TO CONCENTRATIONS IN EXPENSIVE AREAS JUST BEFORE THOSE AREAS SUFFER.

FIGURE 5. THE MOST BUBBLY ASSETS CRASH THE HARDEST

Price return, rebased to 100 at Jan 2019 (log scale)

+1,708%

-75%

16x

8x

4x

2x

1x

0.5x

19 20 21 22

Nasdaq IPOs and SPACs ARKK Money-losing tech AMC Bitcoin

31 Dec 2022 | Source: Refinitiv, Goldman Sachs, Orbis. IPOs are companies that recently had an initial public offering. SPACs are special purpose acquisition companies. Money-losing tech is the Goldman Sachs Non-Profitable Technology Index. AMC shares fell over 80% between 2019 and 2020 before rapidly increasing during the "meme stock" craze.

A CHANGE OF LEADERSHIP

Winners also tend not to persist. In every era, the continued success of the biggest companies seems certain. In 1989, business school students in America rushed to copy the practices of Japanese companies, which were outcompeting their peers everywhere. In 1999, it seemed inevitable that Cisco, as the enabler of the internet revolution, would grow to the sky. As the West struggled and China ascended in 2007, commodity companies and Chinese enterprises seemed assured of success. Today, it is difficult to imagine a market without the gargantuan growth of Apple, Microsoft, Alphabet, Amazon, and Meta. Yet over the past 30 years, only Microsoft has managed to stay among the world's ten largest companies. If the past is a guide, the world's most valuable companies will be a very different list ten years from now.

This is a unique problem for passive funds, which hold shares in proportion to their market capitalisation. That feature makes indexing a stealth momentum strategy—a huge benefit to passive investors through the persistent trending market of the last decade, but a danger when the trend reverses.

In 2007, when Apple launched the first iPhone, its share price doubled. But the company was much smaller then. With a market cap of $75 billion and a weight of 0.3% in the MSCI World Index, its huge share price gains contributed just 0.3% to passive portfolios' returns. In 2020, when Apple revolutionised the world by marginally improving the iPhone's camera, its share price also doubled. But having started the year with a market cap of over $1 trillion and a weight of 3% in the index, this time its rocketing share price added a full 3% to the returns of index funds. The same is true in the other direction. When Exxon fell 20% in 2015 with a 1.2% weight in the Index, it hurt passive investors much more than when it fell 40% in 2020[6] with a 0.3% weight.

As long as trending continues, winners keep getting bigger and making greater contributions to index returns, while losers keep getting smaller and detracting less from passive returns[7]. But as Figure 6 shows, this benefit becomes a risk when trends reverse. Massive exposure to Japan was brutal at the start of 1990, as the Japanese market fell by more than half over the next two years. Massive exposure to tech was brutal in March 2000, as the Nasdaq fell over 70% before bottoming. Massive exposure to Chinese state-owned companies looked clever in October 2007, but share prices fell as much as 75% during the global financial crisis. They are still down 45% from their peak today.

FIGURE 6. LEADERSHIP USUALLY CHANGES WITH EACH MARKET SHIFT

Top 10 globally by market capitalisation

Japan bubble Dec 1989	TMT bubble Mar 2000	GFC / China bubble Oct 2007	Everything bubble Dec 2021
Nippon Telegraph	Microsoft	Exxon Mobil	Apple
Industrial Bank of Japan	Cisco	General Electric	Microsoft
Sumitomo Bank	General Electric	China Mobile	Alphabet
Fuji Bank	Intel	Industrial & Commercial Bank	Amazon
Mitsubishi Bank	NTT Mobile Comm.	Microsoft	Tesla
Exxon	Vodafone	Gazprom	Meta Platforms
Dai-Ichi Kangyo Bank	Exxon Mobil	Royal Dutch Shell	Nvidia
General Electric	Nippon Telegraph	China Petroleum	Berkshire
Tokyo Electric	Walmart	China Construction Bank	Taiwan Semiconductor
Sanwa Bank	Nokia	China Life Insurance	Tencent

Remain in top 10 as at Jun. '23

30 Jun 2023 | Source: Company websites, FTSE, Orbis. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning. Stock names could be affected by mergers or name changes after the dates shown. Excludes investment trusts and Saudi Aramco. Countries determined based on the headquarters of the company at the time of the regime.

[6] Having been a member of the Dow Jones Industrial Average for 92 years, Exxon was booted out in August 2020. Its share price has tripled since then.

[7] This is also why studies show that a tiny number of stocks generate the bulk of long-term stockmarket returns. That is true—but only for indexes which never actively trade.

MARKETS ARE CONCENTRATED IN RECENT WINNERS

The lesson from history is that passive exposure leads to concentrations in expensive areas just before those areas suffer. That is alarming if we consider how passive portfolios have evolved since the global financial crisis.

FIGURE 7A. EQUITY MARKETS ARE CONCENTRATED IN THE US

Weight of US stocks in the MSCI World Index, last 15 years

31 Jul 2023 | Source: MSCI, Orbis.

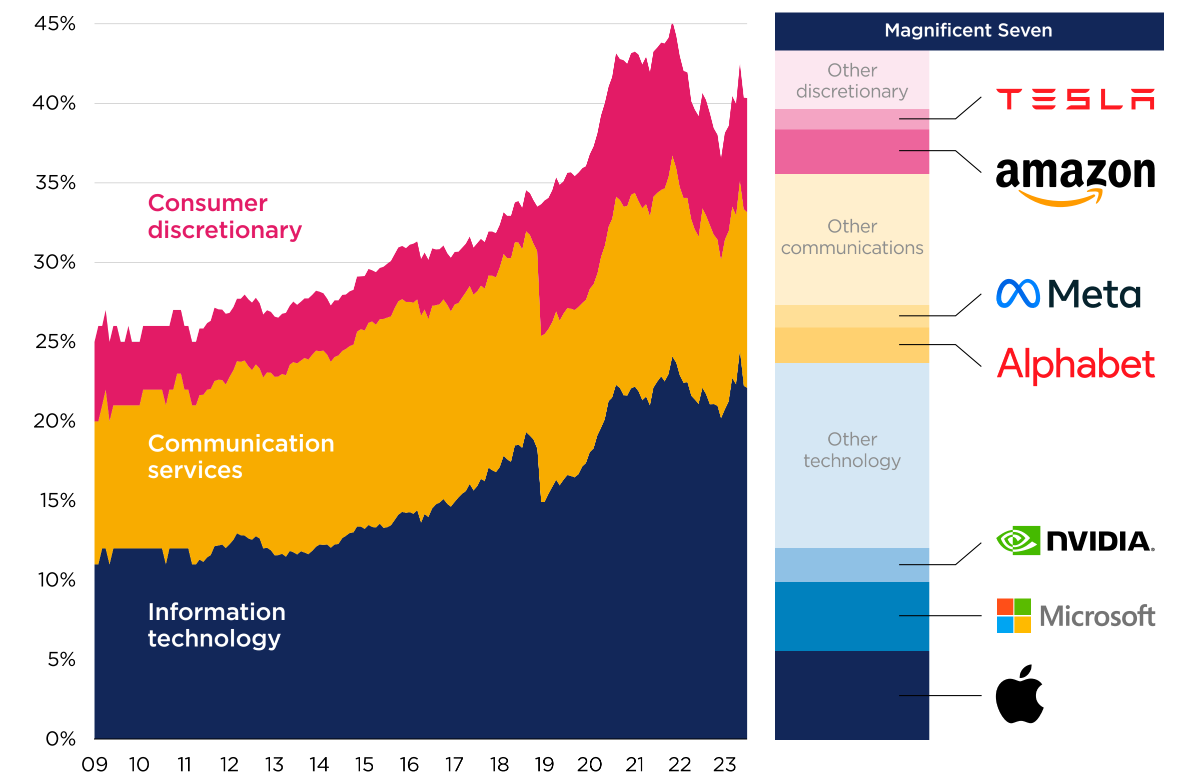
FIGURE 7B. EQUITY MARKETS ARE CONCENTRATED IN GIANT COMPANIES

Weight of mega-cap stocks in the MSCI World Index, last 15 years

31 Jul 2023 | Source: MSCI, Orbis. Mega-cap stocks are defined as those with market capitalisations above $50 billion.

FIGURE 7C. EQUITY MARKETS ARE CONCENTRATED IN TECH SHARES

Weight of sectors and top stocks in the MSCI World Index, last 15 years



31 Jul 2023 | Source: MSCI, Orbis. The Magnificent Seven are the seven largest companies in the MSCI World Index by market capitalisation.

In 2009, a passive investor in the MSCI World Index had a 50% exposure to the US, ⅓ of their portfolio in giant companies, and a 10% exposure to tech. Over the subsequent years, that portfolio has grown more American, more dominated by giants, and more tech heavy. Stockmarkets are now heavily concentrated in the US (70%), giant companies (⅔), and in technology shares (25%). The magnificent seven alone account for close to 20% of global passive portfolios.

A static investment strategy has not led to static exposures, but increased concentrations in the winners of the last decade.

That has been rewarding for investors as momentum has persisted. But as 2022 showed, it carries risks. Each of those three areas is more richly valued than its opposite. The US market trades at 22 times earnings, versus 14 times for shares elsewhere. Giant stocks trade at 20 times earnings, while the median global stocks trades at 17 times. Tech shares are valued at 30 times expected earnings, while other industries are valued at just 16 times in aggregate. Passive exposure to global stockmarkets has led to heavy concentrations in the most richly valued parts of the market.

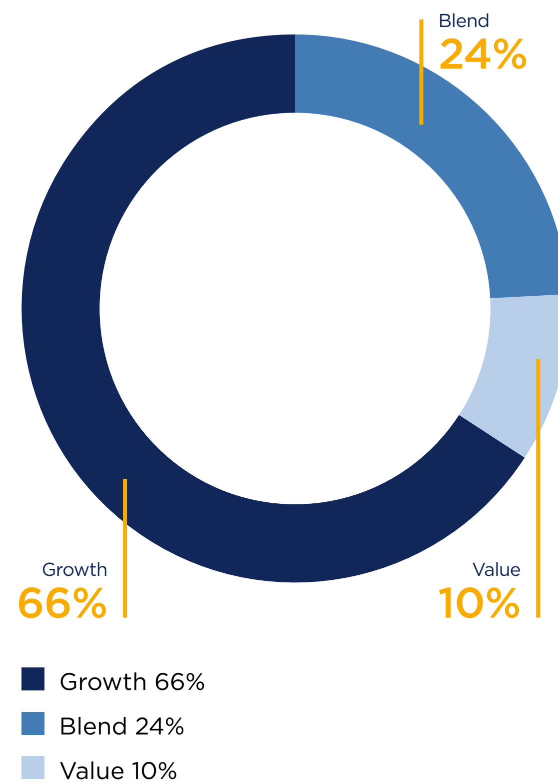
INVESTORS ARE CONCENTRATED IN RECENT WINNING STYLES

That would be alarming enough, as close to 70% of the assets in Australia's 10 biggest retail global equity funds are in passive strategies[8]. But investors have also actively allocated to styles best suited to the day that is now approaching dusk. If we look just at the 10 biggest active retail global equity funds in Australia, Figure 8 shows that 66% of active assets are in growth strategies—those that generally pay higher prices for companies expected to grow more quickly. Only 10% of assets are in value strategies.

Concentration in growth has worked fantastically well over the past 15 years. The largest active fund which has a growth style, trounced the broader market and a blend of the three biggest active global equity funds, which all have a growth style, beat the broader market over the same period.

FIGURE 8. INVESTORS ARE HIGHLY CONCENTRATED IN GROWTH FUNDS

Equity style split for Australia's 10 largest active retail global equity funds[1]



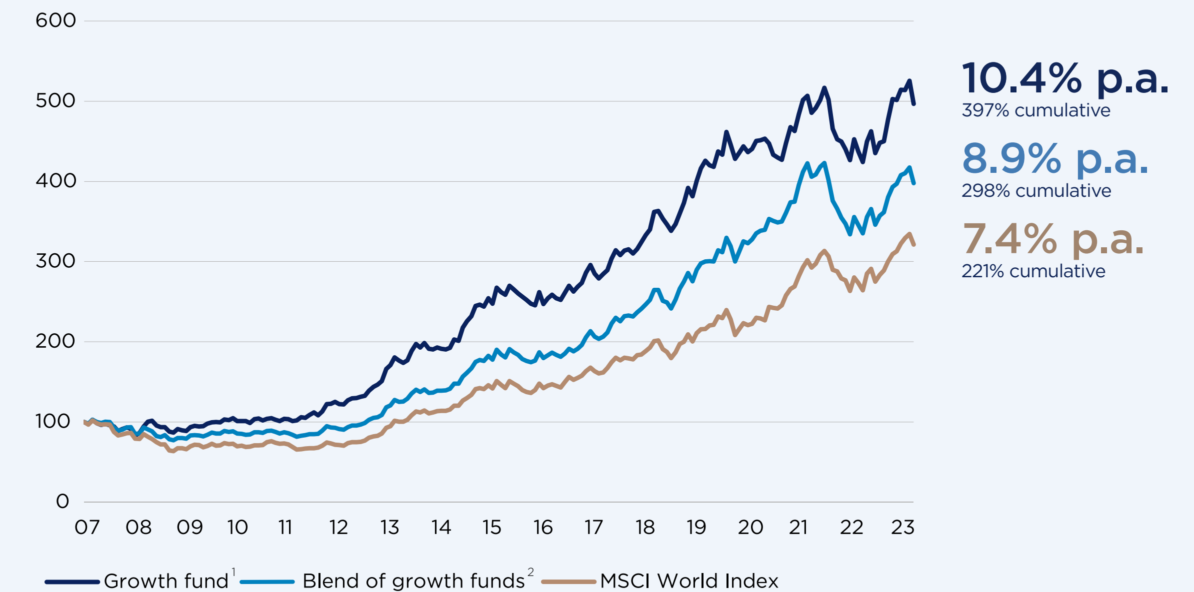
- Growth 66%
- Blend 24%
- Value 10%

Source: Zenith Investment Partners, Morningstar, Orbis. [1]The 10 biggest active retail global equity funds is based on retail unit trust size, sourced from the 2022 Zenith Investment Partners International Shares Sector Report, November 2022. Active is defined as all long-only funds excluding those in the index categories. Hedged vehicles have also been excluded to avoid the duplication of funds. The style for each fund has been categorised using the Morningstar Style Box, which is based on the latest available portfolio holdings for each fund.

A STATIC INVESTMENT STRATEGY HAS NOT LED TO STATIC EXPOSURES, BUT **INCREASED** CONCENTRATIONS IN THE **WINNERS** OF THE LAST DECADE.

FIGURE 9. IT HAS BEEN A GREAT ENVIRONMENT FOR GROWTH-STYLE FUNDS

Total returns (in AUD, rebased to 100 at 30 June 2007)



Past performance is not a reliable indicator of future results.

30 Sep 2023 | Source: Zenith Investment Partners, Morningstar, Orbis. Blends assume monthly rebalancing. The largest active retail global equity funds is based on retail unit trust size sourced from the 2022 Zenith International Shares Sector Report, November 2022. Active is defined as all long-only funds excluding those in the index categories. Hedged vehicles have also been excluded to avoid the duplication of funds. [1]The largest active retail global equity fund, net of fees. This fund has a growth equity style. [2]An equal-weighted blend of the three largest active retail global equity funds, net of fees. Each of these funds has a growth equity style. The common inception date for the three largest active retail global equity funds is 30 Jun 2007.

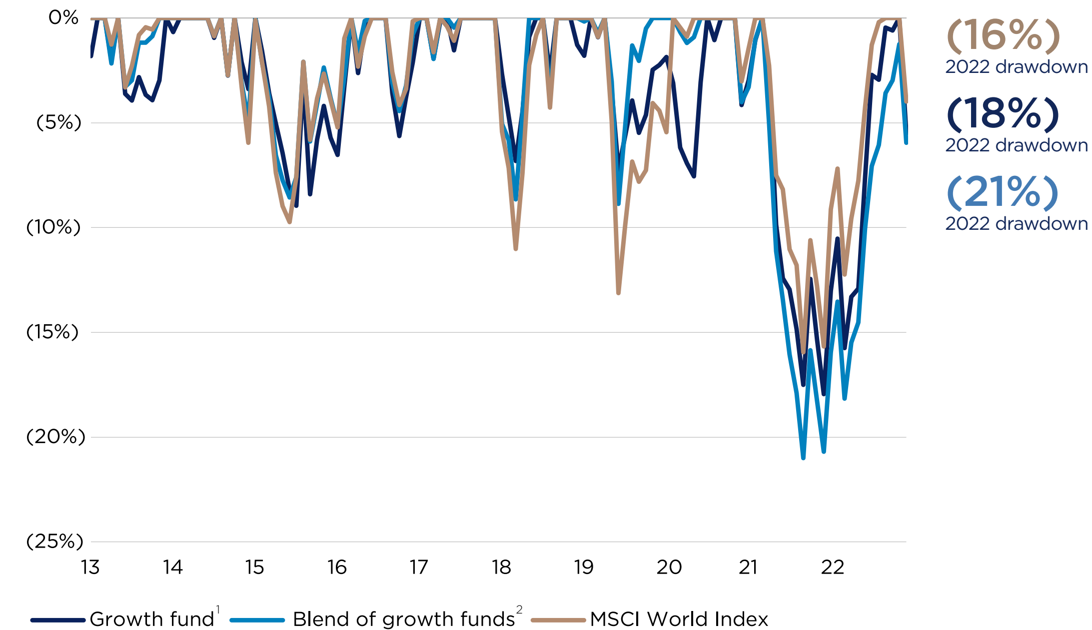
That is not just down to luck. While we prefer to focus on valuations, managers with a sound growth philosophy and the structure to stick with it over the long term can deliver very healthy returns.

The trouble is what happens when that falls out of favour. If investors hold multiple active funds to get diversification, but those active funds invest in very similar things, investors can end up being diversified in name only. But as Figure 10 shows, being diversified only in name is painful when trends change.

[8]The 10 biggest retail global equity funds is based on retail unit trust size sourced from the 2022 Zenith Investment Partners International Shares Sector Report, November 2022. Passive is defined as those funds in index categories.

FIGURE 10. HOLDING SIMILAR FUNDS IS RISKY WHEN THAT STYLE FALLS FROM FAVOUR

Drawdowns (from peak, using monthly total returns in AUD)



Past performance is not a reliable indicator of future results.

30 Sep 2023 | Source: Zenith Investment Partners, Morningstar, Orbis. Blends assume monthly rebalancing. The largest active retail global equity funds is based on retail unit trust size sourced from the 2022 Zenith Investment Partners International Shares Sector Report, November 2022. Active is defined as all long-only funds excluding those in the index categories. Hedged vehicles have also been excluded to avoid the duplication of funds. [1]The largest active retail global equity fund, net of fees. This fund has a growth equity style. [2]An equal-weighted blend of the three largest active retail global equity funds, net of fees. Each of these funds has a growth equity style. The drawdowns for the last 10 years is shown.

In 2022 the broader global equity market fell around 16%, and after a bit of a recovery this year, it is still down around 4%. The largest active retail global equity fund, which has a growth style, fell slightly more with a decline of 18%. Attempting to diversify by holding the two other largest active retail global equity funds did not help at all because they also have a growth style. Investors in that mix of funds saw declines of 21%, and are still underwater today.

Yet investors remain concentrated, with the bulk of their active assets in growth-style funds, and their passive assets concentrated in giant US technology shares. With valuations where they are today, that worries us. Investors are not prepared for sunset. If they do not adjust their portfolios, they will need to adjust their expectations.

IF INVESTORS HOLD MULTIPLE ACTIVE FUNDS TO GET **DIVERSIFICATION**, BUT THOSE ACTIVE FUNDS INVEST IN VERY SIMILAR THINGS, INVESTORS CAN END UP BEING **DIVERSIFIED** IN NAME ONLY.

3

PREPARING FOR SUNSET

INVESTORS CAN PREPARE FOR THE NEXT DECADE BY GETTING PROPERLY DIVERSIFIED

- INVESTOR POSITIONING REMAINS SKEWED TO GROWTH
- VALUE STOCKS HELP DIVERSIFY EQUITY EXPOSURE
- VALUE STOCKS ARE STILL ATTRACTIVE

After a long day in the sun for passive and growth portfolios, it is easy to fear sunset. But there are ways to get properly diversified.

INVESTOR POSITIONING REMAINS SKEWED TO GROWTH

Figure 10 showed the dangers of being diversified in name only. Holding multiple active retail funds did little to reduce risk in 2022 when all three of the biggest active global equity funds had highly correlated growth styles. Yet, worryingly, investors seem positioned for a repeat of 2022. To see this, we have grouped stocks by style into one of three categories: value, core and growth. Today, a passive global equity investor continues to have a sizeable concentration towards growth stocks, which accounts for around 35% of the overall exposure.

Most investors do not hold 100% of their portfolio in a passive fund, however. A more useful yardstick is a starting portfolio of 50% passive and 50% of the three largest active retail global equity funds. But this 50/50 portfolio does nothing to improve diversification from a style perspective. Indeed, this portfolio has an even heavier concentration towards growth stocks accounting for 43% of the overall exposure – more than 2.5 times than that of value stocks. And it's even worse if you only held Australia's three largest funds, leaving you with 53% exposure to growth—almost 10 times the exposure to value stocks.

FIGURE 11. INVESTOR POSITIONING REMAINS SKEWED TO GROWTH

	MSCI World	50% MSCI World 50% three largest funds[1]	100% three largest funds[1]
Value	24%	16%	6%
Core	41%	41%	41%
Growth	35%	43%	53%

Source: Zenith Investment Partners, Morningstar, Orbis. [1]An equally-weighted portfolio of the three largest active retail global equity funds is based on retail unit trust size sourced from the 2022 Zenith Investment Partners International Shares Sector Report, November 2022. Active is defined as all long-only funds excluding those in the index categories. Hedged vehicles have also been excluded to avoid the duplication of funds. The exposure to Value, Core and Growth has been calculated using the Morningstar Style Box, based on the latest available portfolio holdings. Figures may not sum due to rounding.

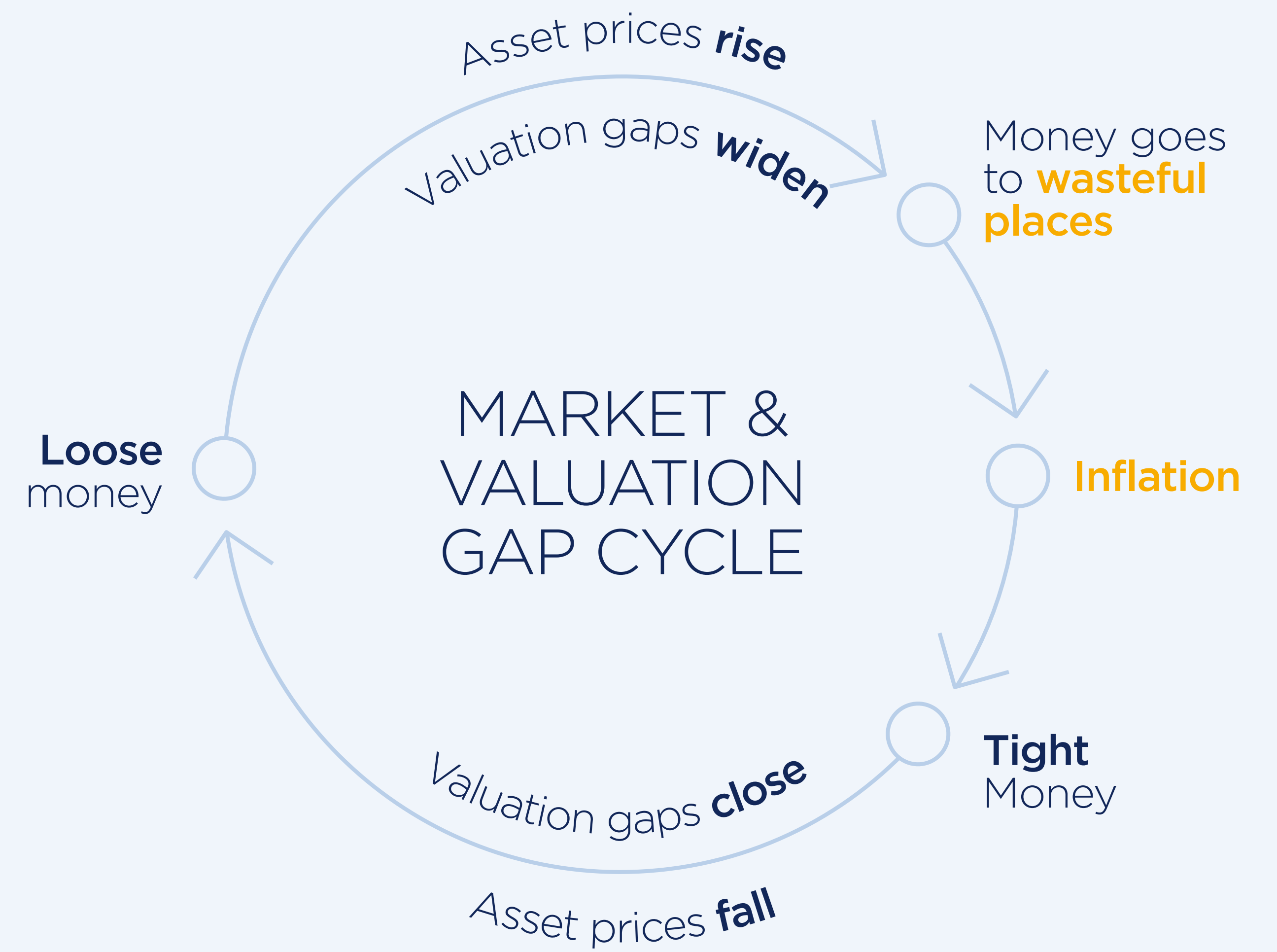
VALUE STOCKS HELP DIVERSIFY EQUITY EXPOSURE

The conundrum is that most portfolios have most of their assets in equities. With stockmarkets expensive, why should equities still deserve such a place in a portfolio?

The key is to diversify across styles within equities. Markets in aggregate are expensive—but not uniformly expensive. We have seen this before, too. While most of us are familiar with the cycle of broad asset prices and interest rates, there is an equally important cycle unfolding at the same time—the cycle in valuation gaps.

When money is cheap, asset prices rise, and the prices of speculative assets rise the most. That channels money to wasteful places, which drives inflation, and ultimately prompts higher interest rates. The resulting downcycle is unpleasant for passive investors, and painful for those holding the most expensive assets. But there are undervalued assets, too—the companies that were neglected during the euphoric easy money times. Simply holding these assets can make a remarkable difference to investors' returns in downcycles. Holding expensive stocks can be painful when bubbles burst.

FIGURE 12. MARKET & VALUATION GAP CYCLE



HOLDING **EXPENSIVE** STOCKS CAN BE **PAINFUL** WHEN BUBBLES BURST

FIGURE 13. VALUE ASSETS CAN DELIVER MUCH BETTER RETURNS WHEN BUBBLES UNWIND

Returns (USD) (not annualised)

Bubble	Dates	Return of expensive stocks	Relative return of value vs expensive stocks
60s and Nifty Fifty	Feb 1966 to Oct 1974	(25%)	68%
Dot-com bubble	Mar 2000 to Oct 2002	(66%)	186%
Everything bubble	Jan 2022 to Dec 2022	(22%)	19%

31 Dec 2022 | Source: Orbis, Kenneth French. Dates shown are for the bubble periods in earlier slides, to the closest month end for each period. Expensive stocks include lossmaking companies and the bottom 40th percentile of stocks ranked on earnings-to-price in the Fama-French dataset. Cheap stocks are the top 40th percentile of stocks ranked on earnings-to-price. Relative returns for each month are calculated arithmetically in line with the Fama-French factor return methodology, and the blue column shows the ending value of an investment in cheap stocks divided by the ending value of an investment in expensive stocks, minus one.

The column on the right shows the difference in returns between value and expensive stocks during these three major sunsets. Simply holding stocks at low price multiples made a transformative difference to investor returns. Active managers can do even better—there are thousands of stocks in world markets, and hundreds trading at low price multiples. We only need to find a few dozen that are attractively priced.

VALUE STOCKS ARE STILL ATTRACTIVE

Value has suffered a long, dark night. Having thrived for nearly a century, value has lagged since the global financial crisis, suffering the deepest and longest drawdown in its history. But Venus turns. That underperformance has left value stocks trading at exceptionally attractive prices, even after a good year in 2022. In a still-expensive market that has grown ever-more concentrated in richly-priced US, mega-cap, and tech shares, value stocks offer both a refuge and a source of opportunity.

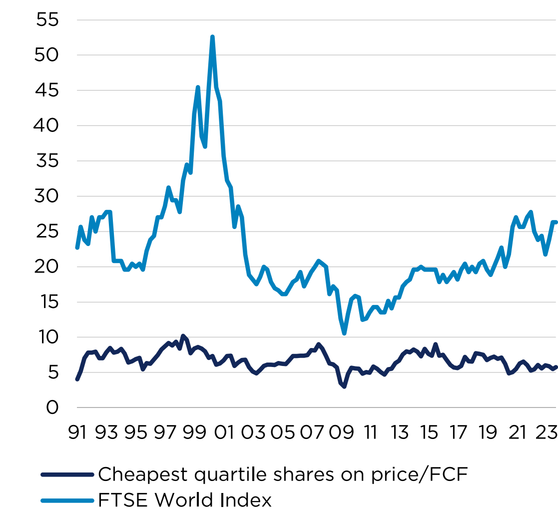
In Figure 2a, our grand unified chart of stockmarket valuations, we looked at a dozen different measures. Combining different measures gives a stronger signal across the wide range of periods, regions, and types of companies in world stockmarkets.

But as fundamental, long-term, contrarian investors, we look at companies like business owners, and as business owners, the single most important metric is free cash flow. If you own a business outright, free cash flow is your money—to reinvest in profitable projects, buy a competitor, pay down debt, pay out dividends, or buy out your partners. It is the single measure that best captures the true worth of a business. And if we look at the free cash flow valuations of the most neglected companies, we see reasons for excitement.

That is not true for the market as a whole, as Figure 14 shows. On a price-to-free-cash-flow basis, we see the same pattern as for the other measures. In the years since the global financial crisis, markets in aggregate have got more expensive, and are currently near their richest levels since the original Tech bubble in 2000.

FIGURE 14. CASH FLOW IS UNDERAPPRECIATED

Price/free cash flow (FCF) of cheapest quartile shares on price/FCF and the FTSE World Index



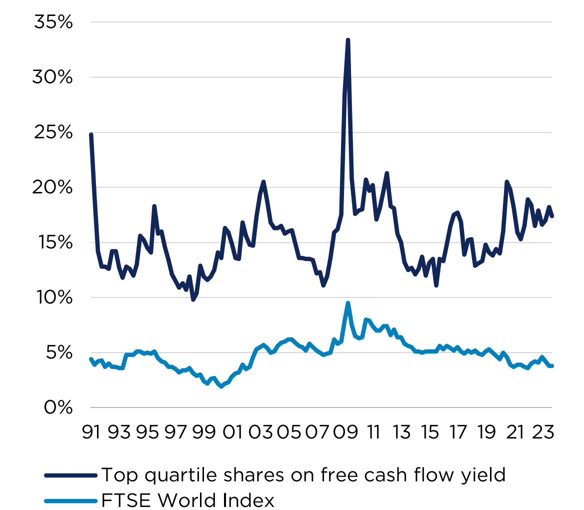
31 Jul 2023 | Source: Orbis, Worldscope. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning. In each case, calculated first at the stock level and then aggregated using a median.

The pullback of 2022 barely made a dent. The typical global stock trades at over 25 times free cash flow. If you owned it outright, it would take 25 years of current cash flow to get your money back. Investors are hoping for rapid growth. In fact, the market's valuation is so stretched that the multiple of the neglected shares is barely discernible.

We can change that by inverting the ratio, and looking at free cash flow yield, or free cash flow divided by price. This reveals a more promising picture.

FIGURE 15. THERE IS PLENTY OF VALUE AVAILABLE FOR ACTIVE STOCKPICKERS

Trailing free cash flow (FCF) yield of top quartile shares on FCF yield and the FTSE World Index



31 Jul 2023 | Source: Orbis, Worldscope. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning. In each case, calculated first at the stock level and then aggregated using a median.

While the overall market is expensive, the most neglected quarter of shares offer free cash flow yields of 17%. If you bought one of these businesses outright, and assuming cash flows stay flat, you would reap an ongoing return of 17% per year. You could get your entire investment back in about six years—and could still own a profitable business at the end of that period.

This excites us, as it suggests a wider opportunity. Cash flow is underappreciated at a time when investors desperately need the diversifying benefits of value stocks.

4

SUNRISE ON VENUS

THE NEW WORLD IS RISKY FOR PAST WINNERS, BUT SHOULD BE REWARDING FOR VALUE INVESTMENTS

- VALUE SHARES MAKE UP THE BULK OF THE ORBIS GLOBAL EQUITY FUND
- THE ORBIS GLOBAL EQUITY FUND IS AN EFFECTIVE DIVERSIFIER
- THE ORBIS GLOBAL EQUITY FUND LOOKS VERY DIFFERENT FROM GROWTH-HEAVY PASSIVE AND ACTIVE FUNDS

VALUE SHARES MAKE UP THE BULK OF THE ORBIS GLOBAL EQUITY FUND

Discounts to the true worth of a business can take many forms. Having researched hundreds of businesses to find those that trade at compelling discounts, we believe we've built an attractive portfolio. In aggregate, the Orbis Global Equity Fund trades at a 41% discount to the wider market on a free cash flow basis as at 31 July 2023, and similarly if we look at conventional accounting earnings. That is an unusually wide discount.

FIGURE 16. ORBIS GLOBAL AND MSCI ACWI PORTFOLIO CHARACTERISTICS

	Price/earnings (forward)	Price/free cash flow (trailing)
Orbis Global Equity Fund	14	17
MSCI All Country World Index	22	29
Discount	**36%**	**41%**

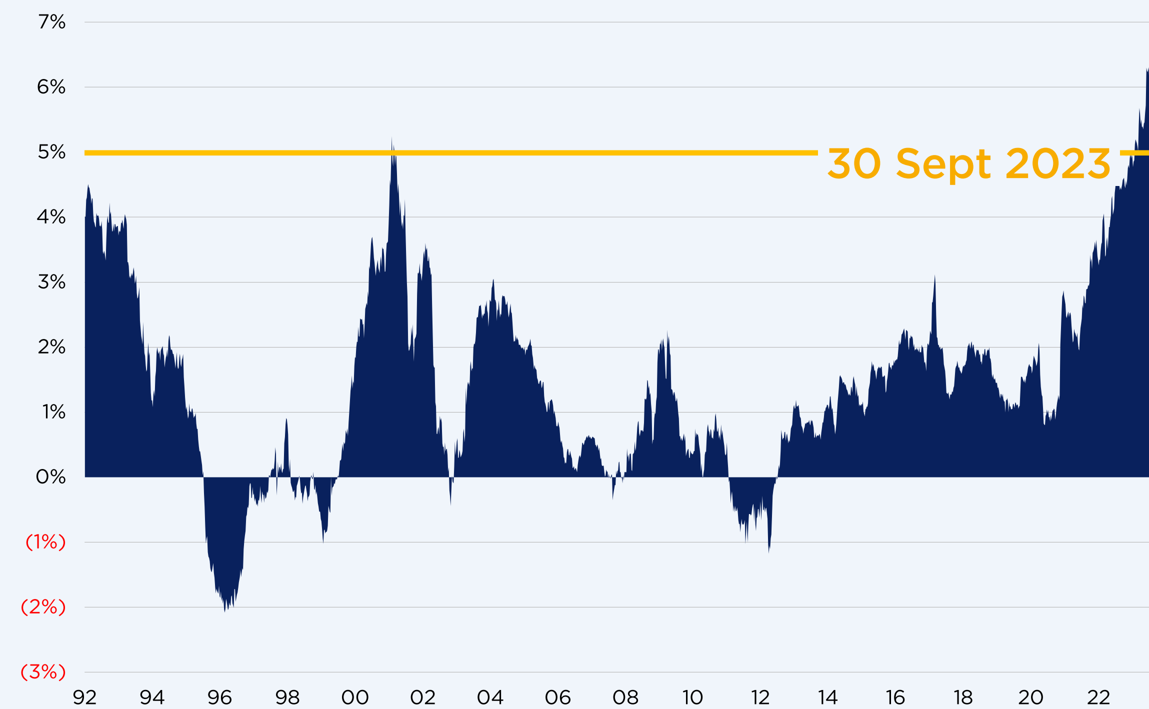
31 Jul 2023 | Source: Worldscope, Orbis. In each case, calculated first at the stock level and then aggregated using a weighted median. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning.

And importantly, we don't believe we're sacrificing anything in the way of business prospects to get that discount. Our analysts have uncovered shares in a wide range of industries that we believe are much better positioned than last decade's winners for the environment ahead.

Another way to gauge the value orientation of the Orbis Global Equity Fund is its exposure to the value 'factor', in essence, how closely does the Fund trade with the value factor on a week-to-week basis? That is shown in Figure 17. The Fund's exposure to the value factor is near its all-time high, matching peaks from the 1990s Japan bubble and 2000s Tech bubble.

FIGURE 17. ORBIS GLOBAL EQUITY VALUE FACTOR EXPOSURE

Orbis Global Equity net Value factor exposure[1]



30 Sep 2023 | Source: Worldscope, MSCI, FTSE. Data is for a representative account of the Orbis Global Equity Strategy. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning. The Orbis Global Equity Strategy's inception date is 1 January 1990. [1]Factor style analysis uses statistical regression to forecast the net exposure of the portfolio to movements in the proxy style index. A positive (negative) exposure indicates the portfolio is likely to benefit from a positive (negative) move in the proxy style index.

The Orbis Global Equity Strategy is an asset weighted composite of all Orbis Global Equity Funds which follow the same investment objective, including those funds which are not registered for sale to retail investors in Australia. We use the strategy to demonstrate certain investment themes which are generally consistent with the Australia domiciled funds, which include the Orbis Global Equity Fund. The Fund and the strategy share the same investment philosophy and almost identical stocks and geographical and sector allocations. Divergence does occur due to timing associated with subscriptions and redemptions and certain regulatory constraints. Consequently, actual returns and value factor exposure experienced by investors in the Australian domiciled Fund will not be the same as the strategy.

THE ORBIS GLOBAL EQUITY FUND IS AN EFFECTIVE DIVERSIFIER

Passive funds and the biggest active retail global equity funds in Australia remain heavily skewed to growth equities. We can balance the blend by introducing a different style. The Orbis Global Equity Fund's contrarian style and value exposure can make it an effective diversifier, balancing growth-heavy passive and active equity exposures, as shown in Figure 18.

FIGURE 18. BLENDING GOOD ACTIVE MANAGERS WITH DIFFERENT STYLES CAN IMPROVE PORTFOLIO DIVERSIFICATION

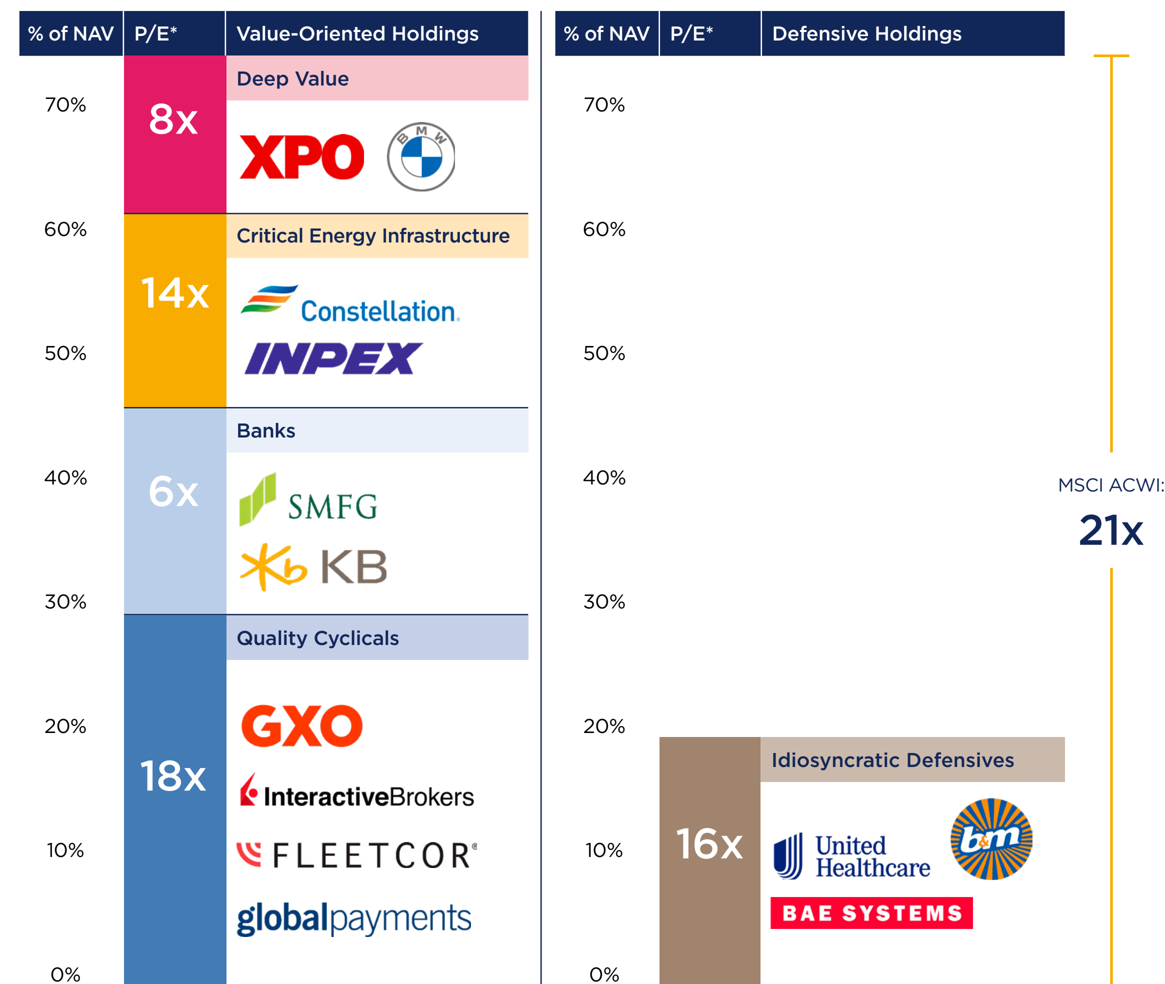
	MSCI World	50% MSCI World 50% three largest funds[1]	100% three largest funds[1]	50% Contrarian value[2] 25% three largest funds[1] 25% MSCI World
Value	24%	16%	6%	31%
Core	41%	41%	41%	40%
Growth	35%	43%	53%	30%

Source: Zenith Investment Partners, Morningstar, Orbis. [1]An equally-weighted portfolio of the three largest active retail global equity funds is based on retail unit trust size sourced from the 2022 Zenith Investment Partners International Shares Sector Report, November 2022. Active is defined as all funds excluding those in the index categories. Hedged vehicles have also been excluded to avoid the duplication of funds. [2]The Orbis Global Equity Fund, net of Retail Class Fee. The exposure to Value, Core and Growth has been calculated using the Morningstar Style Box, based on the latest available portfolio holdings. Figures may not sum due to rounding.

AS FUNDAMENTAL, LONG-TERM, CONTRARIAN **INVESTORS**, WE LOOK AT COMPANIES LIKE **BUSINESS OWNERS**.

THE ORBIS GLOBAL EQUITY FUND LOOKS VERY DIFFERENT FROM GROWTH-HEAVY PASSIVE AND ACTIVE FUNDS

FIGURE 19. ORBIS GLOBAL EQUITY: PORTFOLIO AT-A-GLANCE



30 Sep 2023 | Source: Orbis, IBES, Company websites. % of NAV is for a representative account of the Orbis Global Equity Strategy and includes all securities held in the respective grouping. The Orbis Global Equity Strategy is an asset weighted composite of all Orbis Global Equity Funds which follow the same investment objective, including those funds which are not registered for sale to retail investors in Australia. We use the strategy to demonstrate certain investment themes which are generally consistent with the Australia domiciled funds, which include the Orbis Global Equity Fund. The Fund and the strategy share the same investment philosophy and almost identical stocks and geographical and sector allocations. Divergence does occur due to timing associated with subscriptions and redemptions and certain regulatory constraints. Logos shown for a selection of positions greater than 1%. *P/E is calculated as a weighted median for each respective grouping and is based on IBES estimates for EPS in the current fiscal year. 'Other Value' represents shares trading at less than 10x P/E. Exceptions to these rules are made. Not every strategy holding is classified in the illustrated groupings. 'Idiosyncratic Defensives' represents shares with a beta (3-year trailing avg.) below 0.9. Exceptions to these rules are made. Not every strategy holding is classified in the illustrated groupings.

The Orbis Global Equity Fund holds just 1% in the magnificent seven (as at 30 Sept 23), a small position in Alphabet which we added as tech fell in 2022 and have trimmed recently after it outperformed. That compares to the market at 19%. US shares make up almost 70% of the market, but less than 50% in the Fund as we have found compelling value elsewhere. And while there are some great companies in the Tech and Communication Services sectors, we've found opportunities totaling just 11% of the Fund, compared to 29% (as at 30 Sept 23) for the market.

Figure 19 shows the Fund's larger exposures, grouped by theme. We invest bottom up, but themes often emerge. Today, the value-oriented themes dominate, and include high-quality cyclical businesses, banks across Japan, Korea and Europe, as well as critical infrastructure, energy and materials businesses. These groups all trade at discounts to the market multiple.

On the other hand, we are fortunate to also find shares with fundamentally defensive characteristics. These span the globe and the underlying businesses are highly diversified, ranging from a Korean defence contractor to US health insurers. We expect many of them to grow at above-average rates, yet they still trade at discounts to the market. As we build the portfolio from the bottom up, investment opportunities are constantly competing for capital. The portfolio has changed over time, and will again. We are highly active investors, and we are happy to be different from the benchmark and peers. Over the 33 years since we launched our Global Equity Strategy, our approach has worked well: going around the world company by company, seeking real diversification and value assets. The Strategy and Fund have outperformed the benchmark since inception.

IN OUR VIEW, WE ARE JUST GETTING STARTED. WHILE MANY INVESTORS FEAR SUNSET, WE ARE LOOKING FORWARD TO THE NEXT SUNRISE.

ORBIS GLOBAL EQUITY FUND: PERFORMANCE, PLATFORM AVAILABILITY AND RATINGS

The Orbis Global Equity Fund has outperformed its benchmark since inception. The Fund holds a 'Recommended' rating from both Lonsec and Zenith and is available on all major Australian platforms.

FIGURE 20. ORBIS GLOBAL EQUITY: LONG-TERM RETURNS

	Strategy	Fund					
Returns (% annualised, AUD)	Since Strategy Inc. (1 Jan 1990)	Since Fund Inc. (30 Jun 2005)	10 Years	5 Years	3 Years	1 Year
Orbis Global Equity, net	11.2	8.8	10.7	7.3	12.4	27.5
Benchmark, net of WHT	7.3	7.9	12.0	9.0	10.7	20.6
Net Relative Return	**3.9**	**0.9**	**(1.3)**	**(1.7)**	**1.7**	**6.9**

30 Sep 2023 | Each return figure is for the relevant period ending on 30 September 2023. Net returns from 1 January 1990 of the Orbis Global Equity Strategy (Strategy) are illustrative. From 2005, returns shown are net of retail fees applicable to the Orbis Global Equity Fund (Australia Registered) (Fund) and are calculated arithmetically. Actual returns experienced by investors in the Fund will not be the same as the Strategy (which is an asset weighted composite of all Orbis Global Equity Funds which follow the same investment objective, including those unavailable in Australia). Australian investors interested in the Strategy should invest in the Fund. An investment in the Fund carries risk and past performance is not a reliable indicator of future results.

FIGURE 21. PLATFORM AVAILABILITY

ANZ Wrap	Federation Alliance / Linear	MLC Wrap	PortfolioOne
Asgard	Grow Wrap	Navigator	Praemium
Australian Executor Trustees	Hub 24	Netwealth	Summit
BT Panorama	IOOF	North	Wealthview
CFS Edge	IOOF eXpand	Oasis	
Colonial First Wrap	Macquarie Wrap	OneVue	
Core Equity Services	Mason Stevens	Power Wrap	
		PortfolioCare	

FIGURE 22. FUND RATINGS

The rating issued April 2023 is published by Lonsec Research Pty Ltd ABN 11 151 658 561 AFSL 421 445 (Lonsec). Ratings are general advice only, and have been prepared without taking account of your objectives, financial situation or needs. Consider your personal circumstances, read the product disclosure statement and seek independent financial advice before investing. The rating is not a recommendation to purchase, sell or hold any product. Past performance information is not indicative of future performance. Ratings are subject to change without notice and Lonsec assumes no obligation to update. Lonsec uses objective criteria and receives a fee from the Fund Manager.

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WHILE MANY INVESTORS FEAR SUNSET, WE ARE LOOKING FORWARD TO THE NEXT SUNRISE.

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Returns

Net returns for Orbis Funds are calculated gross of all income, net of fees and expenses, and assume reinvestment of dividends.

Strategy Returns

This document may refer to the Orbis Global Equity Strategy. The Orbis Global Equity Strategy is an asset weighted composite of all Orbis Global Equity Funds which follow the same investment objective including those funds which are not registered for sale to retail investors in Australia. The returns in this presentation are an asset weighted actual net return of all Orbis Global Equity Funds. Actual returns experienced by investors in the Australia domiciled Funds will vary and will not be the same as that of the strategy. We use the strategy to demonstrate certain investment themes which are generally consistent with the Australia domiciled Funds, which include the Orbis Global Equity Fund (Australia Registered). The Australia domiciled global equity Funds and the strategy share the same investment philosophy and for most part, the same stocks and geographical and sector allocations. Divergence between the funds do occur due to timing associated with subscriptions and redemptions and certain regulatory constraints.

Benchmark Information

The Orbis Global Equity Fund (Australia Registered) changed its Benchmark on 1 January 2021 from MSCI World Index to MSCI All Country World Index With Special Tax (AUD) (MSCI ACWI Special Tax). Returns prior to 1 January 2021 relate to MSCI World Index.

Sources

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New Zealand

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