The Long-Term Benefits of Global Investing

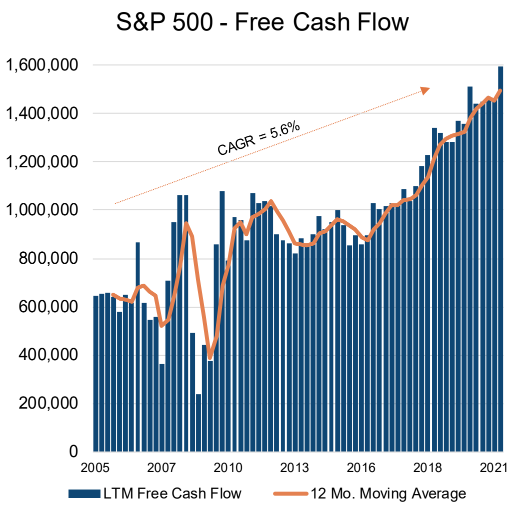
FAYEZ SAROFIM & CO.

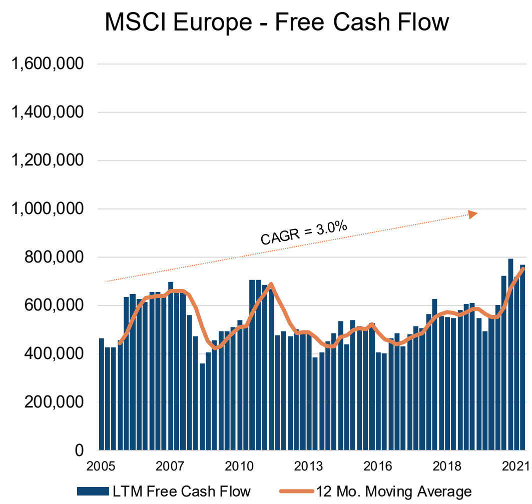
While there is a natural tendency for investors to want to disproportionately invest in equities based in their home country, aka "home bias," there are many positive reasons from an opportunity set and diversification standpoint to invest on a global basis. A common misconception is that international developed and emerging market stocks would make a portfolio riskier, but since international and emerging market stocks are not always correlated to the stocks of the home country, a portfolio could see greater diversification with lower volatility. For instance, even though the U.S. represents approximately 61% of the MSCI ACWI (All Country World Index) market capitalization, U.S. companies represent only 21%, or 629, of the 2,959 total companies in the index.[1] There are 2,330 international companies in the MSCI ACWI Index, or 79% of the index, demonstrating the opportunity for investors to find the best companies in the world, regardless of where the companies are headquartered.

As an active global manager, Fayez Sarofim & Co. invests in leading, quality companies around the world, not global stock markets. Indices do not necessarily represent the best growth opportunities, especially outside the U.S., as fundamental research of individual companies can represent a better way to uncover investments with attractive long-term growth prospects, while also avoiding the companies that do not possess the proper growth or economic moats around their businesses.

In the U.S., the information technology, communication services, consumer discretionary (includes consumer technology such as Amazon) and health care sectors constitute approximately 63% of the S&P 500 index.[2] International indices generally have a greater concentration of value-oriented stocks in "old economy" sectors such as financials, materials, and energy. This index weighting dynamic alone accounts for much of the decade-long return disparity between U.S. and non-U.S. stocks, as U.S. stocks have benefited from meaningful exposure from technology companies such as Microsoft, Apple, Meta Platforms Inc., Alphabet and Amazon. In addition to delivering superior revenue growth, these companies have generated strong profit and free cash flow generation over the past decade, driving the U.S. market to significantly outperform other global stock indices such as the MSCI Europe Index on a free cash flow basis.

Chart 1





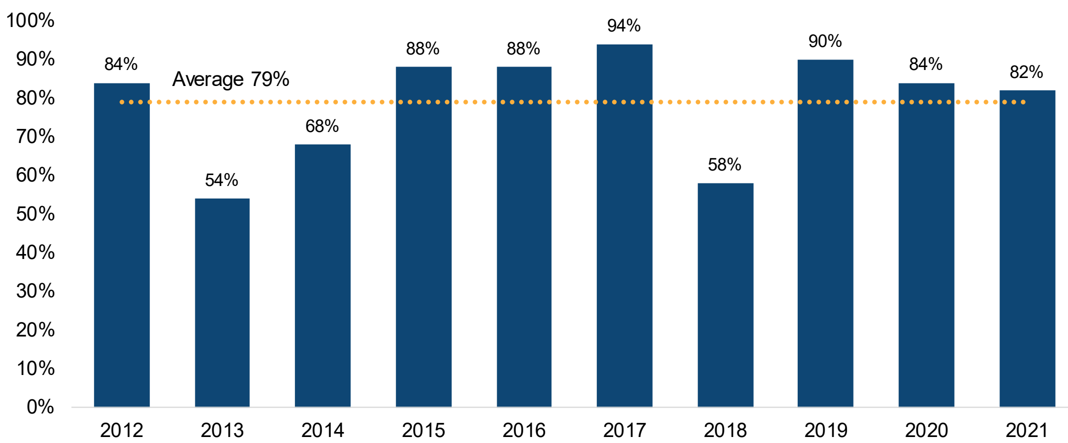
Source: Facstet Market aggregates, Bernstein. Data as of 12/31/2021.

Demonstrating the opportunity for active management internationally, while the top ten companies in the S&P 500 Index represent 29.7% of its total index weighting, the top ten companies in the MSCI ACWI Ex-US Index represent only 11.1%.[3] This highlights the potential to add value for active, global asset managers like Fayez Sarofim & Co. that are benchmark agnostic who focus on bottom-up company fundamentals. While global investors can obtain their global exposure through a combination of regional funds, Fayez Sarofim & Co. is able to evaluate the best companies globally as opposed to by country, enabling increased flexibility with its mandate to find potential returns that are superior to global indices on a risk-reward basis.

BEST PERFORMING STOCKS HAVE PRIMARILY BEEN OUTSIDE THE U.S.

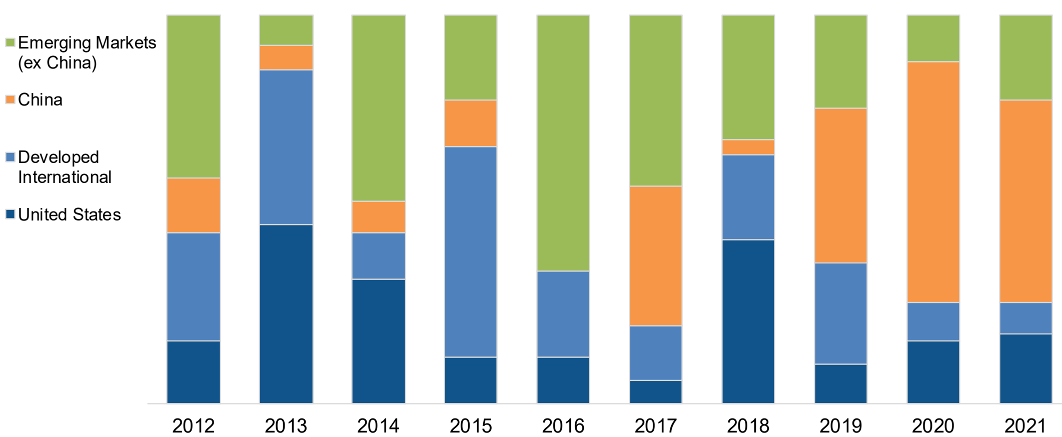
While U.S. markets have outperformed international markets by a wide margin in the years following the global financial crisis, index-based returns do not represent the full story. In fact, the companies with the best annual returns each year have been mostly based outside of the U.S., demonstrating there are consistently attractive international investment opportunities for global investors. Non-U.S. companies comprised approximately 79% of the MSCI ACWI Index's top 50 performers on average over the past decade, with a combination of companies headquartered in developed international markets, emerging markets (ex-China) and China.

Chart 2: Percentage of Non-US Stocks Among Top 50 Performers in MSCI ACWI



Source: Factset. Data as of 12/31/21.

Chart 3: Number of the Top 50 Stocks Each Year by Company Location



Index Returns	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
U.S.	16.0%	32.4%	13.7%	1.4%	12.0%	21.8%	-4.4%	31.5%	18.4%	28.7%
Non-U.S.	16.8%	15.3%	-3.9%	-5.7%	4.5%	27.2%	-14.2%	21.5%	10.7%	7.8%

Source: Facstet, MSCI, RIMES. Data as of 12/31/2021. Top 50 stocks are the companies with the highest total return in the MSCI ACWI each year. Returns table uses Standard & Poor's 500 and MSCI ACWI ex USA indexes for U.S. and non-U.S., respectively.

While many investors look at benchmarks or invest on a country basis, Fayez Sarofim & Co. analyzes the attractiveness of a business from a fundamental perspective as well as the revenue and operating profit exposure by geographic region for each of its global portfolio holdings. Given the meaningful shift towards globalization over the last few decades, the address of a company's headquarters has become less important to a company's overall growth prospects. While economic and political dynamics in a company's home country or region remain factors for a company's stock performance, these factors have become less critical as companies have expanded their geographic exposure away from their home markets. Analyzing a company's revenue and operating profit exposure by geographic region enables Fayez Sarofim & Co. to understand a company's geographic growth exposures and the profitability of that growth.

To illustrate, premium spirits company Diageo plc is headquartered in London, England, and so one might assume that Europe is the most important region for Diageo and its growth. On the contrary, Europe represents only 20% of Diageo's total net sales and only 17% of its total operating profit, while North America is Diageo's largest and most profitable market, generating 41% of its total sales and 57% of its total operating profit in its fiscal year 2021.[4] Diageo's operating margin in North America was 42.9% in its latest fiscal year, much higher than its total company operating margin of 29.4%, driven by its scale and leadership positions across spirits categories such as scotch, tequila and Canadian whisky. Understanding these geographic growth drivers, companies' market share positioning within these regions and their forecasted evolution gives Fayez Sarofim & Co. insight into how its companies will generate long-term, sustainable growth along with the resilience of this growth during times of macroeconomic headwinds in particular geographies.

An example of an attractive, high-growth, high-margin industry dominated by international companies is the luxury goods sector, where European companies are among the world's largest players, centered in France, Italy, and Switzerland with companies such as LVMH Moët Hennessy Louis Vuitton, Hermès International, Kering, and Richemont. LVMH, headquartered in Paris and controlled by the Arnault family, is the leading luxury goods company in the world with sales in 2021 of €64.2 billion, more than three times its next closest competitor. Despite its size, LVMH continues to outgrow the luxury goods industry, demonstrating the craftmanship, brand power and aspirational nature of its portfolio.

Over the past few decades, but notably during the last five years, LVMH and Hermès have seen an inflection point in growth, driven by robust sales growth in China. Both companies have significantly benefited from the rise in consumer spending in China, as the combination of a growing middle class, premiumization, e-commerce penetration, growth in travel retail and strong demand for luxury brands has led to outsized revenue gains in this important market of over 1.4 billion people. These companies represent prime examples of non-Chinese companies that can benefit from the large magnitude of consumer spending in China with high-end global brands, while possessing greater Western market corporate governance and controls and accounting transparency. With the Chinese government cracking down on many domestic industries over the past year, the changing regulatory landscape has caused notable weakness in many Chinese stocks that have been negatively affected by these changing market structures. LVMH and Hermès have not seen any negative impacts due to these regulatory changes and the "Common Prosperity" initiative, with consistent consumer spending in the upper-middle and affluent class, which represents the bulk of its consumer base.

Over the last fifteen years, LMVH's revenue exposure has significantly increased to faster-growing Asian markets such as China, while its exposure to slower-growing developed markets such as France, Europe and Japan has decreased. To illustrate, in 2006, LMVH's geographic revenue breakdown was 15% France, 22% Europe (ex-France), 26% United States, 17% Asia (ex-Japan), 13% Japan and 7% Other Markets. In 2021, LVMH Moët Hennessy Louis Vuitton SE generated only 6% of its 2021 global revenue in its home country of France, with 35% in Asia Pacific (ex-Japan), 26% United States, 15% Europe (ex-France), 7% Japan and 11% Other Markets.[5] Thus, LMVH's revenue exposure to Asia (ex-Japan) has increased from 17% in 2006 to 35% of total revenues in 2021, while its revenue exposure to France, Europe and Japan has fallen from approximately 50% in 2006 to 28% in 2021.

Hermès International, also headquartered in Paris, France, has seen a similar revenue dynamic, with a 2006 revenue exposure of 19% France, 19% Europe (ex-France), 27% Japan, 17% Asia Pacific (ex-Japan), 15% Americas and 3% Other. For the full year 2021, Hermès revenue by geographic region was 9% France, 15% Europe (ex-France), 47% Asia Pacific (ex-Japan), 11% Japan, 16% Americas and 2% Other.[6] Hermès revenue exposure has increased from 17% Asia Pacific (ex-Japan) in 2006 to 47% in 2021, while its exposure to France, Europe, and Japan has fallen from 65% of its total revenue in 2006 to 35% in 2021.

The travel retail channel has continued to grow in China despite the pandemic due to the development of Hainan as a domestic duty-free travel destination within China, which has further supported consumer consumption of high-end luxury brands. The creation of internal consumption in China is being supported by government actions, which represents a positive long-term trend for the luxury industry. The development of Hainan has been beneficial to consumer spending growth since the pandemic as domestic travel for Chinese consumers has effectively replaced international travel for the time being. Hainan serves a significant number of consumers not only from the largest cities but also Tier 3 and Tier 4 cities, areas where there is less brick-and-mortar distribution in the luxury segment, enabling consumers to shop for luxury products beyond the e-commerce channel. It is estimated that only 12% of Chinese consumers have a passport (per Estée Lauder management), meaning that even when international travel comes back, the Hainan phenomenon goes well beyond international travel as it appeals to the entire population.[7] As a result, luxury management teams expect Hainan to continue to grow even when international travel restarts, which should continue to benefit LVMH and Hermès.

The business models of LVMH and Hermès are unique and compelling given they possess among the strongest pricing power in the consumer industry for their iconic, aspirational brands with high barriers to entry, strong competitive moats, high returns on capital, low capital intensity, robust balance sheets, and an exceptional long-term track record of compounding revenue and profit growth at a high level. These companies have proved to be remarkably resilient even during historical economic downturns. Demonstrating its strong pricing power, Hermès was one of the world's only luxury brands to pass on price increases in 2009, immediately post the global financial crisis. Consumer demand continues to outpace the limited supply of these luxury brands, which adds to the exclusivity and halo around these brands.

As a result of their superior growth algorithm within the consumer sector, LVMH has generated a cumulative total return of +833% and Hermès has generated a +1,349% cumulative total return in U.S. dollars over the past fifteen years, significantly outpacing the return of the MSCI World Index of +193% over the same period. LVMH and Hermès are examples of dominant, global companies with headquarters outside the U.S. that would have been overlooked by U.S.-only investors. These companies possess strong management and corporate governance and represent an attractive, lower risk way to play the long-term growth of consumer spending in China.

In addition to geography, Fayez Sarofim & Co. looks at sales mix by channel to analyze operating margin dynamics and to forecast the long-term margin potential of a company's business. An example is cosmetics company Estée Lauder Companies, which has generated double-digit net revenue growth driven by global market share gains in the prestige beauty category. In addition to strong net revenue growth, the company has driven meaningful operating margin expansion over the past decade as its business has transitioned into higher-margin channels such as online and travel retail and away from lower-margin department stores. As a result of this evolution in channel mix, Estée Lauder's operating margin has increased from 7.0% in FY2009 to 18.9% in FY2021.

To illustrate, in fiscal year 2009, Estée Lauder's largest sales channel was department stores, representing 56% of total sales (26% international, 30% North America), while travel retail was 7% of sales and the online channel was small (brand.com sales represented only 1% of total sales). Over the past decade, Estée Lauder's stellar growth has been primarily driven by the online and travel retail channels, both of which are higher margin than its company average. Online represented 28% of Estée Lauder's total sales in fiscal year 2021 (18% brand.com and 10% retailer.com), while travel retail also represented 28% of its total sales, primarily driven by the growth of Chinese consumer spending in the travel retail channel globally.[8]

The explosion of e-commerce with platforms such as Tmall has also been beneficial to Estée Lauder, as historically in emerging markets, the company could only grow as fast as its physical infrastructure of stores. The company's most distributed brand in China is brand Estée Lauder, which is in 140 cities in China. With a strong social media presence, aspirational nature of the brand and e-commerce platforms, the Estée Lauder brand has demand in almost 700 cities in China, vastly outpacing its physical infrastructure of stores, which has significantly accelerated the growth of its brands in China in a margin-accretive manner. Skin care is such a significant beauty category in China because face condition is an important symbol of hygiene, social status, and beauty. According to Estée Lauder management, while women in the U.S. and Europe have on average 1-2 steps of skin care routine in the morning and 1-2 steps at night, women in China have on average 7 steps of skin care routine in the morning and 7 steps at night. This statistic highlights the significant long-term opportunity the company has in China as more consumers use high-quality skin care, trading up from mass to prestige beauty.

Department stores, which represented 56% of the company's total sales in FY2009, only represented 21% of total sales in FY2021, as Estée Lauder's sales in North America have transitioned to other channels such as online and specialty-multi stores such as Sephora and Ulta. Estée Lauder management has done a fantastic job of investing aggressively in these fast-growing, higher-margin channels globally and shifting its business model to a more diversified channel base with more durable growth. With gross margins over 76%, Estée Lauder has the long-term potential for further operating margin expansion beyond its 18.9% operating margin in FY2021. Due to this strong financial performance in revenue, margins and earnings per share, Estée Lauder's stock has achieved a +582% cumulative total return over the past ten years, meaningfully outperforming global indices.

While it is important to identify the most attractive sub-sectors for investment, it is even more important to identify the companies within those sub-sectors that possess the most compelling long-term returns. For example, in the software space, there has been a stark difference in performance from the largest software firm in the U.S. and the largest software firm in Europe. Headquartered in the U.S., Microsoft Corporation is the largest software company in the world with $168 billion in revenue and $70 billion in operating profit in fiscal year 2021. This compares to the largest software company based in Europe, SAP SE, which is headquartered in Germany and is forecasted to generate €27.5 billion in revenue and €8 billion in operating profit in calendar year 2021.

Microsoft has evolved to become the most important information technology partner to enterprise customers globally. Under CEO Satya Nadella, Microsoft has successfully transitioned its business and benefited from the ongoing shift to cloud services through its cloud platform, Azure. Microsoft's commercial cloud revenue, which includes Azure, Office 365 Commercial, the commercial portion of LinkedIn, Dynamics 365, and other commercial cloud properties, has expanded from $16.2 billion in fiscal year 2017 to $69.1 billion in fiscal year 2021, equaling a 43.7% revenue compound annual growth rate (CAGR).[9] With a #2 position behind Amazon's AWS, Microsoft's Azure is in an enviable competitive position, as barriers to entry in the public cloud business are extraordinarily high as the leading vendors are constantly expanding their feature sets and lowering prices through economies of scale.

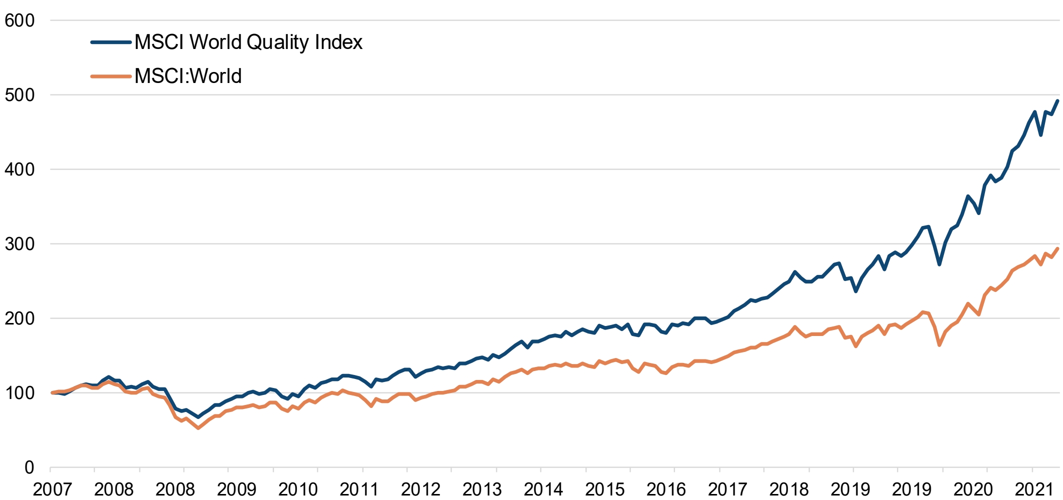
Primarily due to its accelerating strength in cloud services, Microsoft has generated a four-year revenue CAGR of +14.9%, a +25.4% earnings per share CAGR, and a +15.2% free cash flow (non-GAAP) CAGR. In the five years from FY2017 to FY2021, Microsoft returned ~$150 billion to shareholders, with ~$70 billion of dividends and ~$80 billion of net share repurchases.[10] As a result of this impressive financial performance, Microsoft stock has generated a cumulative total return of +457% over the past five years.

On the other hand, the European region offers fewer software companies than the U.S., especially companies that possess the size and global scale of many of the larger U.S. software companies. SAP has struggled in transitioning customers from its on-premise software model to a cloud-delivered model, causing the company in October 2020 to lower its medium-term operating profit guidance (2023) by 25% compared to estimates at the time. From 2017 to 2021, SAP generated a +4.4% revenue CAGR. SAP management recently stated that its operating margin will be under pressure though 2022 as it will increase R&D spending to better tailor its Enterprise Resource Planning (ERP) software product to certain industries.

SAP SE has also seen turnover at the leadership level, with CEO Bill McDermott leaving SAP in October 2019 to become CEO of U.S. software company ServiceNow, while SAP co-CEO Jennifer Morgan stepped down from her role in April 2020. Given the difficult transition that SAP has seen with its business model, SAP stock has generated a cumulative total return of +72% over the past five years, trailing Microsoft by over 380% over that period. While software has been an attractive sub-sector for investors, this example demonstrates the importance of going beyond a sector theme and using fundamental company analysis to find the most attractive, global companies with accelerating financial performance and strong management teams that are effectively transitioning their business models to capture additional market share.

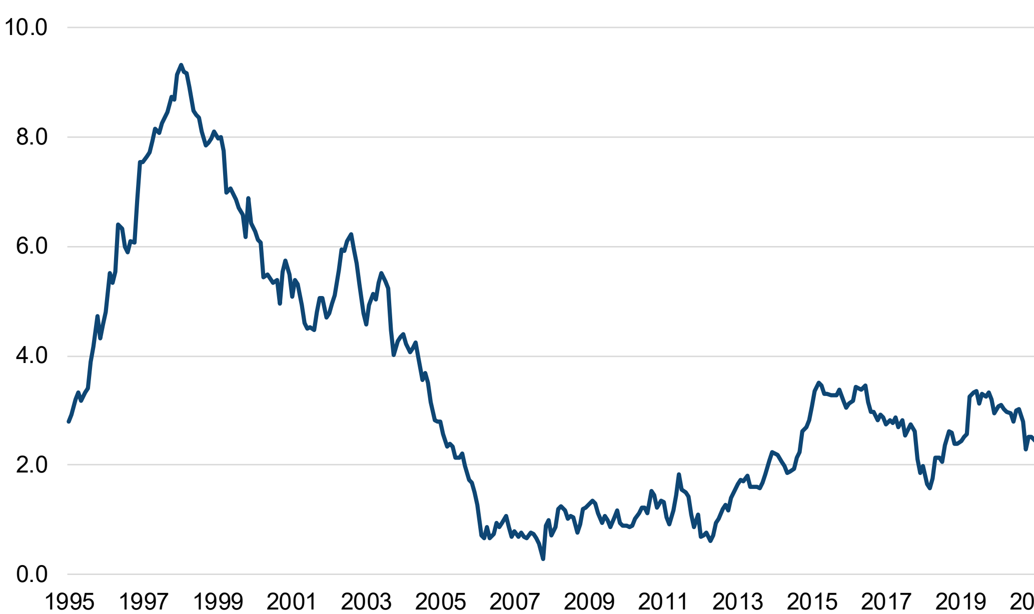
To illustrate the potential benefit of investing with an active manager like Fayez Sarofim & Co. that invests in high-quality companies over the long term, quality (represented through the MSCI World Quality Index) has materially outperformed the MSCI World Index by a cumulative 190% on a gross basis over the past fifteen years. This quality index has outperformed the MSCI World Index in eleven of the past fourteen years and for five years consecutively. Amazingly, the MSCI World Quality Index has always performed as well or better than the MSCI World Index for every ten-year rolling period over the past twenty-five years, demonstrating the potential outperformance of active management. Chart 5 below shows the excess returns of investing in the quality index compared to its benchmark over rolling ten-year periods.

Chart 4: Cumulative Index Performance



Source: MSCI Inc. Data as of 12/31/2021.
The ending value for the MSCI Quality Index was $492.3 and the ending value for the MSCI World Index was $293.2.

Chart 5: MSCI World Quality Index vs MSCI World Index Rolling Ten-Year Excess Returns



Source: MSCI. Data as of 12/31/21.

In conclusion, active, global investing has many potential benefits from a diversification standpoint as well as through potential portfolio construction and performance differentiation from global indices. While non-US indices have trailed the U.S. indices over the past decade, companies outside the U.S. have consistently represented most of the world's top 50 performers on average on an annual basis, highlighting the attractive international investment opportunities for active, long-term global investors. While the portfolio holdings an active manager holds is crucial for performance, it is also important for a manager to understand the stocks and exposures it doesn't own, given there can be idiosyncratic upside or downside risks that can arise from specific country dynamics, as most recently shown in China with downside risks resulting from changes in government regulation. For decades, Fayez Sarofim & Co. has invested in leading, quality multinational companies with durable growth and sustainable competitive advantages that possess attractive exposure to many of the world's leading economies, while at the same time limiting downside risks by focusing on company fundamentals, balance sheet strength, and maintaining corporate governance standards at the highest level.

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[1]MSCI ACWI and MSCI ACWI ex US fact sheets as of February 28, 2022.

[2]S&P Dow Jones Indices LLC. S&P 500 weightings as of February 28, 2022.

[3]FactSet as source for S&P 500 top ten weights and MSCI ACWI ex US Index fact sheet for top ten weights. The weightings of Alphabet Inc. Class A and Alphabet Inc. Class C are totaled as one company in the top ten. As of February 28, 2022.

[4]Diageo FY2021 financial press release, presentation, and Annual Report 2021.

[5]LVMH financial presentations and publications.

[6]Hermes International financial presentations and publications.

[7]Estée Lauder management commentary on Q1 FY2022 earnings conference call on November 2, 2021.

[8]Estée Lauder FY2021 financial press releases, management commentary from FY2021 earnings call, and FY2021 Investor Fact Sheet.

[9]Microsoft 10-K SEC filings.

[10]Microsoft financial earnings reports and financial presentations.