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TRANSCRIPT

Perspectives Podcast "Investment Trends in Focus: Quarterly Roundtable Q3 2024"

Transcript, 11 July, 2024

Adam Bass (00:04):
This is MSCI Perspectives, bringing to light insights and analysis to help global investors tackle today's challenges. I'm your host, Adam Bass, and today is July 11th, 2024. As we sat down to record this episode, it was just a few days after the US celebrated its 148th Independence Day, and voters in the UK overwhelmingly voted to shift power to the Labor Party for the first time in 14 years. And just one day after we learned that the far-right National Rally party in France had in fact been denied the victory that everyone expected. We also happened to be exactly one week into the third quarter or more to the point into the second half of 2024. It was an ideal time to assemble our quarterly panel under the agile moderation of MSCI's Chief Research Officer, Ashley Lester. This time around the panel looked at the short and long-term issues affecting investors including the geopolitical landscape, all through the lens of the five key themes that Ashley laid out at the start of the year. Here's that conversation.

Ashley Lester (01:19):
Hello and welcome to the MSCI Perspectives Quarterly Roundtable where we explore the most pressing issues facing investors around the world. I'm your host for today, Ashley Lester. I'm the chief research officer at MSCI, and today I am joined by a panel of MSCI experts who will share their insights and perspectives on 2024 as we reach the midpoint of the year, what's happened so far and what might come next. With inflation having stayed higher than anticipated by markets at the start of the year, interest rate cuts have been pushed back by the Fed. Today we'll explore what that means for a wide variety of markets, from bonds and currencies to equities, real estate and private assets. We'll also take a look at how AI is continuing to transform equity markets and what that means for active equity strategies, and we'll check in on the world's ongoing transition to sustainable energy sources.
(02:08):
Before we get started, I'll introduce our panelists. First up today we have Raina Oberoi, head of our equity solutions team and resident expert on all things geopolitical. I'm also being joined by Jim Costello, our head of America's real Estate Markets research. And last but not least, Abdulla Zaid from our private capital research team will join our discussion. Abdulla has a special focus in this research on sustainability and private assets. Welcome to the podcast everyone. Let's start with the macro environment. Raina, I mentioned inflation and interest rates have remained higher for longer than markets were signaling at the start of this year. Perhaps you can just set the scene for us what's happened in the key markets this year and what would you say are the outstanding trends that we're seeing in public markets so far?

Raina Oberoi (02:50):
Thanks, Ashley. Thank you for having me. Always good to be back on this podcast. So global stocks have actually continued to trend upward almost more than 11% so far this year, and you would think about that top-line number, but there's a lot happening under the hood. Things are changing, things are rotating. We did see significant shifts among countries, so Chinese stocks, for example, rallied 7% this last quarter while Japanese stocks actually pulled back and were down close to 4% of the last quarter. Now, international investors who invested in Japan actually saw deepened losses with the decline of the yen bringing the importance of currency risks to the forefront. And countries, India maintained their momentum and rallied another 10% this quarter.

(03:40):
But in general, if you think about momentum as a trade, which is basically companies that are doing well, continue to do well, they have done well across developed markets and emerging markets this quarter. Quality and growth have been resilient in developed markets versus value has remained solid outside the US, not so much in the US and we will go into that a little bit more. We do talk about performance a lot because that's something that obviously is on top of mind, but I think something that investors, especially equity investors need to think about is, "What is the underlying makeup of the equity universe that you're investing in?" Because if you think about the broader equity universe and think about how has that evolved over time because that has repercussions in terms of the breadth of the universe, the depth of the universe, and how do you select companies, it has impact on the fundamentals of companies.
(04:28):
And what we've seen actually is a quite nuanced differentiation between developed markets and emerging markets. So in emerging markets, let's start with them. They have actually issued a lot more equity, new issuances to raise capital, etc, increasing equity supply. So you could think about, "Hey, equity markets are actually shrinking versus equity markets actually expanding depending on which part of the world you are in." We think about the global equity universe. You think about these different nuances because that impacts stock selection, it impacts fundamentals, impacts many different things. You could be buying back stock for very different reasons. It could be a good thing for EPS growth, it could be not a good thing because maybe using capital in a different way that you should be doing instead of buying back stocks.
(05:12):
I think that nuance in general is very important, especially from our standpoint because our investors could be thinking about some longer term strategies, whether it comes from the more of the allocator perspective or the asset manager perspective. And then last but not the least, I do think there are a few trends, Ashley, that you highlighted, which actually or equity investors specifically are extremely relevant. One is definitely thinking about what has happened with interest rates and expectations of interest rates and how that's changed, but also the impact of geopolitics and why currency risk is top of mind given where rates are today. The other area which is becoming extremely important is on energy transition, which is, "Where are public markets going and where are private markets going alongside?"
(06:03):
And I think that to me is becoming important because public markets are evolving in a certain way where private markets and other markets like emerging markets are going to be huge in terms of that transition. And I do think geopolitics is going to be a huge influence regardless of where you are in the short term or long term in terms of risks and opportunities. And then, Ashley, you can obviously highlight the AI component where AI is driving a lot of stocks, it's driving a lot of concentration and equity markets, is something we've spoken about in the past, but I think something that continues to exist and is exacerbating that component and how do we handle that and how are clients and investors handling that because it's becoming clearly a challenge as corporate profits of these companies continue to grow.

Ashley Lester (06:51):
Wow, that's quite a sort of panoramic sweep Raina. Let me just take one or two of those in turn and we can do a little bit of a deep dive on them. One way in which people have been describing this year is that it's the year of elections and we've got, as everyone knows, something like 40% or more of the world's population voting this year. We've already seen a surprising result in the Indian election and just in the past couple of days we've seen a thoroughly unsurprising result in the UK followed by another surprise in France. Aside from just the noise and the headlines in the newspapers, what do you think investors need to do to cut through that noise and think about what the implications of those elections are for allocation decisions or for asset returns going forward?

Raina Oberoi (07:35):

One of the things is it depends what your horizon is. You could be an investor who thinks about these medium term situations or short-term situations. There's some who are like, "You know what? It's going to tie through." And some think about the long-term and almost doesn't matter. So let's think about for example, the Indian elections. Modi's government didn't get full majority, they had to go into a coalition, stocks went down, the Indian rupee went down, everything went down saying, "Okay, you know what? Coalitions are hard. Different parties have to come together. Decision making becomes hard," right? At the end of the day, multiple people are involved and that becomes harder. But taking a step back now everyone's realized, "You know what? Actually it may not be a bad thing for this coalition to come in because now this coalition is now representing one part of the country."
(08:20):
This coalition is representing different sects, different dialects, different religions of that country, which is as India is a pretty secular country and that means maybe actually a good thing for macro stability. So now that is actually beginning a lot of analysts think that's not being priced into the economy or will get priced into the economy over time. And as we've seen, the Indian economy in general has gone up 10% this past quarter. So there's an immediate reaction and there's a long-term repercussion there. For France too, for example, when the left decided to suddenly get the majority and there was a surprise, you did see the euro go down because now its spending will be higher, deficit will be higher, but at the same time the euro stabilized over time.
(09:07):
So there's an immediate reaction and some parties in the ecosystem affected by that and some are not. But what that creates is heightened currency volatility and heightened equity market volatility. And what we've seen is equity market volatility given previous times is still relatively lower. The currency volatility has become much more magnified where a lot of investors are really struggling with not only the interest rate component which creates currency volatility, but the geopolitical component, which again creates equity volatility and creates almost a preference for one currency versus the other if I think what geopolitics. The US, given everything is still considered a safe haven. It is a high yielding currency.
(09:51):
As a result, clients are still flocking to that because at the end of the day, that is where they can find refuge if you will. So I think there is a hedging component that's coming in where clients are beginning to thinking about, "How does hedging come into play in terms of mitigating the currency risk, but what is my safe haven?" And so there's an interest rate component, but there's a geopolitical component that's all coming in together and the currency markets is where what's getting priced in very quickly and is impacting some investors, but not some investors because they have a more long-term horizon.

Ashley Lester (10:28):
I mean, if I think about the financial markets news of the first half of this year so far and think about, "Well, what's the most unusual stuff to be hitting?" I would have to put pretty high up there the fact that the end is depreciated from around 140 to the dollar at the start of the year to about 160 now for one thing as hitting a level that it lasts or nearly 40 years ago. And for another thing, it's probably virtually the first time in that period that the dollar yen exchange rate move has made that many financial headlines. Now in some sense, as you say, Raina, that's driven by geopolitics, in another sense it seems to be driven by just the underlying ongoing strength of the US economy feeding through to continued high interest rates. That seems to be good news for pretty much everyone, certainly in the US, but Jim, is there an exception when it comes to commercial real estate?

Jim Costello (11:17):
Yeah, listen, high interest rates and commercial real estate, they don't go well together. The financing costs go up, other rates of return are out there competing and it's just harder to get capital. Everybody in the commercial real estate world has been looking at the current situation and wishing, hoping and praying that they'd get low mortgage rates again so that the deals that they have in place that they can refinance out of them and have no trouble. That is not quite happening the way many people had wished. It's something that is

a little bit better than it was a few months ago in terms of the current environment. It's not showing up in our figures yet, but when I go out and about talking to clients, they're starting to note that they're seeing a little bit more deal activity starting that the liquidity, it's not there yet, but there's a sense they have that things are starting to bottom out.
(12:09):
And we see that in a few indicators, the number of loans originated. The first quarter, not in the apartment sector, but most other property sectors, the amount of loan dollars originated was higher than it was in the first quarter of 2023, and if you're not getting a loan, you're not buying a property. So the fact that it's a little bit higher there, that's another kind of indicator that maybe the liquidity is starting to improve a bit, but it hasn't translated to any of our performance figures yet. It's not like the other asset classes here. It's a little bit longer run and it just takes time for that to work through.

Ashley Lester (12:45):
Yeah. Let's talk about that relationship between how well an asset's going and the liquidity in the market because I think that's not necessarily always obvious to all of our listeners, but it does seem like kind of a universal rule. I was first exposed to this when I was running quant market risk for Morgan Stanley during the financial crisis. At the time, subprime bonds were the sort of hub of the financial crisis, and as the price of those bonds started to fall, you took a market that previously saw all sorts of liquidity, no problem moving whatever you wanted, and all of a sudden it was totally seized up and in many cases those bonds didn't trade again for another three or four years. So there does seem to be this structural relationship between falling market and loss of liquidity, but also beyond that, I know that we've created some tools od a kind that exploit that quantitatively to think about what would a market clearing price be. So maybe you could talk us through that as well.

Jim Costello (13:41):
Sure. That period of time you're talking about with the subprime, the other phrase that was very common back then to highlight the illiquidity was 'catching a falling knife.' The notion being if I catch a falling knife, if I don't grab the handle, if I catch it too early, I'm losing my fingers. And the problem was that you had a kind of consensus view that things hadn't fully repriced yet and nobody wanted to be the first one to grab things. Now, mixing metaphors here, nobody wants to be that first penguin jumping in the water and getting eaten by the sea lion. They want to see how that other penguin goes first. But that's kind of where we're at right now. We've seen a few big deals move through and people are sitting back and waiting, seeing if maybe things settle a little bit more on the interest rate side so that the mortgages can stabilize to the level where things can underwrite, but we're not quite there yet.
(14:35):
You reference a measurement to liquidity. We have a couple different tools that we use to gauge that. One is a scoring system for 155 markets around the world. Let me just back up what I mean by markets. Raina was talking about markets and detailing how investors are looking at different companies. In the real estate world sometimes people think about this as investing in different, when we say markets, different big urban Agglomerations, Manhattan versus Northern New Jersey versus Osaka versus Mumbai or Shenzhen. So just those different markets. But out of 155, 27 in the first quarter had liquidity scores that were higher than their averages historically. And typically those were markets like Indianapolis, Osaka, Inland Empire, these are areas, they're heavily industrial focused. So people tend to paint commercial real estate with a broad brush, but there's certain sectors that are more problematic. The industrial sector, it is people are consuming goods and more online shopping. There's still a little bit more demand for the industrial sector. So there's a bit of a shift in liquidity for different types of markets in that way too.

Ashley Lester (15:50):

So different sub-sectors of the commercial real estate market are finding their new equilibrium at different rates. I guess that totally makes sense, especially with offices suffering from the pandemic, which as you say is not the case for warehouses.

Jim Costello (16:02):
Right. But even that too, the office phenomenon is more of a problem in a place like New York or Chicago or Seattle, less so in London and Tokyo. There's a whole host of people with opinions on why there are differences. I don't think it works to get into that here, but every market has some of its own unique characteristics that's driving it. You can't paint a broad brush by sector, by city in that way. You need to dig into the details of each one. You have to look at each one to make sure you understand the fundamentals.

Ashley Lester (16:38):
Yeah, exactly. Well, talk about heterogeneous markets. I think it might be time to call on Abdulla, our private asset market specialist. Abdulla, private assets are never that liquid, that's sort of what makes them private in a sense. But I guess even there you could say there are times when they're more liquid and times when they're less liquid, times when the GPs are more likely to sell the assets and times when they're less likely to sell them. So what's happening to liquidity in private assets at the moment?

Abdulla Zaid (17:05):
Well, first thanks for the invite, it's great to be here with you all. So when it comes to liquidity in private capital, I would really categorize that in two different buckets. There is the distribution bucket and there is the fundraising bucket, and those you will see eventually, those are really related to each other almost in a reverse causality as well. So let me start by saying that the common saying that we hear now in the market is that LPs are not paid in IRRs, they're paid in distributions and eventually you really see the difference between IRR and distributions. Those are not the same thing, especially in this type of market environment.

Ashley Lester (17:41):
I think that's a great point. Could you spell out for some of our listeners who may be less many than you with private markets?

Abdulla Zaid (17:47):
Absolutely. So when it comes to IRRs, this is really looking into the cash flows in distributions, contributions meaning capital going to the fund, capital coming out of the fund, as well as the changes in the valuation of the held assets. So if we look into the distribution rates, which is really looking into the capital distributed basically relatively to the valuation of the held assets. So if we're looking into private equity, which was basically the asset class that I saw a lot of headwinds, 12% in 2022, and then going into 10% of valuation in 2023. Now, you're going to compare that to let's say pre 2019 period. That was in the neighborhood of 24, 25%. So we're talking about a big reduction in terms of distributions in the market. That reduction in the market is basically fueling some sort of challenges for fundraising, which I'm going to come back to later.
(18:41):
But to understand the slowdown really in the distributions and the reduction in the distributions of the market, we have to understand the exit market too. So to understand the exit market, just the top line figure I would quote here is that there has been some sort of reduction in excess by 21% in 2022. This is really driving a lot of the lack of distributions. To understand what is happening in the exit market, we have to even go deeper. We have to go to the fundamentals of the portfolio companies and since I'm an economist by training, I have to go back also to the macroeconomics to understand the transmission channels for those types of headwinds that we're seeing in the exit market.
(19:20):
So if we're going to summarize the headwinds coming from the macroeconomic environment into three transmission channels, the first being basically the downward pressure that the macroeconomic environment is

placing on the exit multiples because of the rising cost of capital, and then there are other two transmission channels being the growth outlook and the inflation outlook. Those are going to be impacting the revenue outlook for those companies and the EBITDA or the profitability based on the cost because of inflation. So those two are coming together. And if we look into the portfolio companies, let's say within buyout funds, so if we look into those companies, we're going to see basically what's happening is that we saw an exceptional growth in revenue across these companies in 2021 and that growth kind of slowed until going into 2024, the first quarter of 2024.

(20:12):

In that quarter basically we're seeing that the bottom quarter of companies are even experiencing some sort of level of contraction in terms of revenue, in terms of EBITDA. So you're getting some sort of headwinds not only from the rising cost of capital and liquidity, you're giving headwinds coming from the margins and the EBITDA and the growth and the fundamentals of those companies. Now, this is going to push down multiples at exit, EBITDA multiples at exit, but also is going to do that with the entry EBITDA multiples. So both have been falling and what's happening over the last, let's say, few quarters, you're going to start noticing that there has been some sort of conversions in entry multiples and exit multiples.

(20:53):

And what this tells me, the message that sends me if I had to summarize the exit market today is really a mark of discipline, meaning that GPs are looking into not only the multiples, this is not a multiple expansion as it used to be pre 2020. This is a market of focusing on margins, revenue, growth, fundamentals of those companies. And even if we're looking into the choice that funds or GPs are facing exit now or wait until multiples can increase, this is really looking into the age of the exits and we have seen that age increasing, meaning that GPs are holding some of those assets. So this is again is adding to the lack of distribution.

(21:33):

But with that perfect storm for distribution or lack of distribution, we're going to see that LPs that depend on these distributions to fund new capital costs, to fund new commitments, fundraising, that capital is not even there in the market. So what we're seeing is also the fundraising is kind of slowing significantly. If we look into 2023, the number of funds, this is comparable to 2014, so we're looking into a decade low in terms of fundraising in the private space, now looking into, let's say, the coming quarters, the first what we see to improve is going to be the exit market and then you will see the second short of fall, which is the fundraising environment. This is kind of the order of the events.

Ashley Lester (22:17):

So roughly speaking, if I've got your numbers for a mature private equity fund, a few years ago they would be returning about $1 in four of their valuation to their end investors each year, and now that's more like $1 in 8 or $1 in 10, and that's because they're not seeing such an easy time getting paid a lot to get out of it?

Abdulla Zaid (22:41):

Roughly, yeah. So let's say for 10%, meaning that for 2023 for every $10 in existing valuation returning only $1. In fact, in Q1 of 2024, the most recent quarter, we're seeing even lower distribution rates. I mean, there is some sort of seasonality impact here, but we're looking into 9%. So for every, let's say, $100 hundred dollars, you're returning only $9 compared to let's say 2019, 2018, for every $100 of valuation, you're returning $23.

Ashley Lester (23:13):

I can't out thinking that across all these markets we've been talking about, whether it's subprime or offices in certain market or certain private assets, I'm always reminded of psychology experiment where people were asked to value some essentially worthless thing, a Biro pen or something or like that, they said, "Oh, it's worth 50 cents or something." And someone said, "Oh well, here's 50 cents, will you give me the pen?" They said, "Are you kidding? There's worth at least $3." Sort of feels like that's the mechanism which stops markets from clearing at times like this maybe.

Abdulla Zaid (23:43):
Absolutely. And this actually leads us back to the IRRs because what the IRR is saying is very different. As I mentioned, what we see in IRR in 2023 is there was a 5% performance across private capital funds, and when it comes, let's say, to the first quarter of 2024, we're seeing some sort of flat performance and venture capital buyouts. We're seeing that in performance, those assets are still held, but really when it comes down to the exits, this is what LPs are really looking at at this point.

Ashley Lester (24:11):
It must be pretty uncomfortable for some LPs. I mean, you've got stuff you need to be doing with their money and you're not getting it back.

Abdulla Zaid (24:17):
That is true also, but this is also going to be challenging for the GPs themselves because we're talking about two other kind of moving parts. First the deal making, this is the how fast the GPs are deploying capital, and then also we're talking about dry powder. So dry powder now is at 22%, meaning dry powder is the level that the capital fund has that capital access to that capital but has not been deployed. So this is 22% of the capital the fund has access to. 22% has not been deployed, but this is much lower than what has been historically, let's say around 24, 25% before around the year 2019. So the deal making is outpacing fundraising at this point. We're seeing that funds are still deploying deals, but the fundraising is kind of slower, which means that the dry powder is slowly falling slash and flattening.

Ashley Lester (25:11):
Fascinating times in private markets. I think before we wrap up on what's going on at the moment, perhaps partly driven by the rates environment, I just wanted to come back briefly because I think we sort of slightly cut off our discussion about currencies. Raina, I know that you wanted to extend your thoughts on currency vols and the Japanese yen in particular.

Raina Oberoi (25:31):
Yeah, sometimes currencies becomes a really complicated topic for a lot of investors, but I think simply put, it's really the law of demand and supply bling on currencies today, especially when you think about USD versus yen. Now there's a massive gulf between interest rates in the US versus Japan. As a result, investors that is offloading yen in favor of the USD because the USD just gives them a higher rate. So just going back to just in general currency markets broadly, why are they in the forefront today? I think currency volatility has really disrupted bond and equity markets since the Federal Reserve decided to hike interest rates starting in early 2022. You've also seen elections coming in with India, Mexico, Europe, where you've seen huge currency swings and equity market swings along with the change in the expectation of the Fed's path, etc.
(26:24):
So I think investors who are used to it's a pretty calm currency environment, are not used to that anymore and they're like, "What is going on here?" So that's obviously one component. As I mentioned, geopolitics is the other component. We are like, "I want to neutralize my exposure to a certain currency," or, "I want the US in safe haven." There are all these different things that are playing out which brings currency risk management and just total portfolio risk management at the forefront. Now one of the things that we are seeing is you could be like, "Well, I'm not a really currency investor. I don't believe in currency strategies."
(26:55):
But if you are an equity investor, you are exposed to foreign currencies and you are implicitly taking currency risk. As that, you have to make a bet whether you want to take that currency risk or you want to neutralize it. If you think about today in equity specifically currency risk is now a quarter of the overall risk if you think about it from a US investor perspective who's investing in international stocks. That risk has almost doubled since what it was in 2022. And that is because since then you've seen the Fed has taken a certain stance and that obviously has impacted equity markets and currency markets in general. And then you also seen between your comment

of the Japanese yen and the US dollar, you've seen this high correlation between the US dollar and Japanese stocks.

(27:42):

And that also is, again, impacting portfolios, which is making a lot of investors and our clients discuss currency hedging strategies, which is really to mitigate that risk and neutralize the component of currencies and just make sure that they are exposed to the underlying equity strategy that they want to actually get exposed to. And every time when we bring this up or the hedging conversation comes up, it's like, "Oh well, I should just hedge right?" And hedging is not always a good thing. It depends on what a base currency is, which market are you hedging, what's your time horizon and all those different things actually do matter. US dollar investors obviously benefit because of hedging, but that doesn't mean everyone does that. And I think those are things that you have to take into account when you are thinking about hedging.

Ashley Lester (28:27):

I think that that really rings true. There's a sense I've had for a few years talking particularly to fundamental equity investors that macro risks have become more important for them as a fraction of their total portfolio than they used to. Really what they want to do is pick good companies, but if they're global investors, they're stuck making decisions about macro risks instead. It's an interesting feature of the current environment. Now, another interesting feature of the current environment that active equity investors have to face is the rise and rise of AI that seems to be having all sorts of, let's call it interesting effects on markets right now. Where should we start? Should we think about the MAG-VII and what's left of them or should we... Talk us through this phenomenon.

Raina Oberoi (29:08):

We've talked about this last quarter, we've talked about it all of probably 2023. And what we are seeing is the stocks are still benefiting from AI, the ones that are focused on AI. The problem there is that it is adding to the problem of concentration in markets, especially in the us. If you think about the top 10 forms in the MSCI, USA, IMI, which is the investable market index which covers large, mid, and small, it's now close to 30% or over 30% at the end of June. It was, again, we started 20%, we go 25%, not at 30%. But what is the end to that? We are seeing analysts say corporate profits of these same companies are going to double over a certain period of time. Then what does it mean for this percentage? I think it's more of a target, if you will, and it's kind of more of a use of target because it just keeps going forward and keeps magnifying in that sense.

(30:03):

But we talk about concentration, I think one thing that differentiates a lot of these top 10 names is the fact how crowded are they. If you think about Apple, it's obviously shifted it stance on AI, it's trying to do more on AI. It's still the least crowded name in the top 10 as of end of June. And we did this analysis earlier in April and we saw that Apple was the least crowded, still is the least crowded. But now Nvidia has jumped up as the most crowded name in the top 10, not surprisingly, right? Those are things that especially to your point, active equity managers need to think about. So if we think about where we are in terms of concentration, the developed markets are the most concentrated, they were in 50 years. We are seeing healthcare stocks dominate Europe, we are seeing obviously the tech stocks in the US and we are seeing more of the export value-oriented stocks dominate Japan.

(30:57):

So that is generally a phenomenon. But the US is an extreme situation and that is translating not only the US sector and factor strategies, it's also as a result, dominating global strategies and global investments if you will just because the US is just such a huge component. And one kind of fact, which is very interesting is if you think about as of end of May, June, the top five US sectors, these are technology, financials, healthcare, consumer discretion, industrials, each of them are higher in terms of weight than any of the developed or emerging market countries in the global universe. So IT is 18% or give or take of the global equity universe higher than any country in the entire universe. It's pretty unusual. And if you think about just the US alone, if you take these five sectors, there are 74% of the US market.

(31:56):
So that is the definition of markets and that's the definition of benchmarks because they reflect what the markets do. And that to us is a baffling phenomenon. And I think clients are adjusting to that. Allocators are thinking about how to think about benchmarking because benchmark risk is the single biggest risk that they have to own. Asset managers are thinking about how they actually add value to a benchmark because if you take a bet against a name that is constantly going up, it's obviously really hard to add value. And we are kept coming in with potential solutions in terms of maybe you can cap names, you can think about a capped approach to have a more fair benchmark where perhaps an asset manager or an asset allocator can think about evaluating certain strategies in a more fair fashion.

Ashley Lester (32:38):
Yeah, not so long ago it'd seems difficult to imagine that individual companies would be larger than entire significant stock markets, but that seems increasingly to be the case with some of these top companies like the Nvidia's and the Microsofts. Earnings of these companies are certainly very strong, but it is worth saying that at this point their market caps significantly exceeds it. In the MSCI US for instance, the latest numbers I have is that the top 10 stocks account for about 31% of the market, which is pretty incredible. They also account for about 22% of earnings and growing fast, it has to be said, from a fairly stable basis of about 15 or 16% before the pandemic. The pandemic did a lot of weird stuff to earnings. So growing fast but not as fast as their market cap.
(33:24):
Now this in some ways takes those of us with a long memory back to the 2000 internet boom, which was a previous peak of stock market concentration. It felt like there was some parallels. So for example, generally the top 10 largest stocks tend to be larger in terms of their earnings share than in terms of their cap rate. But back in 2000 that wasn't true. There are some other interesting parallels as well, right? Raina, do you want to talk us through any parallels or differences you see between now and then?

Raina Oberoi (33:53):
I think specific for two thousands, we've obviously exceeded the concentration levels there, so hopefully we can learn something there. Now that was the internet era in the 2000s. You saw some of the big forms like the Cisco's of the world, the top 10 forms then accounted for 20% US market cap, give or take. Now, the lesson there is that generally such leaders do give up their market share in the decade that follows. And what we saw there is that those same companies that accounted for 20% of US market cap now account for only 10% and have given up their market share to companies that have evolved with business models. And I think we've seen that in every era that's played out. One other thing which is similar but different is compared to the past, we've noticed that at least today we noticed that there've been some huge swings in the names around earnings announcement.
(34:48):
So the stock specific volatility, this is not market volatility, but volatility associated with the particular stock has been quite unusual in terms of levels where things like Nvidia, Tesla, etc swinging really up and down depending on what the earnings expectations is and what the eventual outcome is. And it's become so pronounced that these big names actually collectively in these top 10 names are actually higher than the rest of the market. And you would think that the smaller cap names typically are more volatile, but that's not the case anymore. And we are seeing that actually across the larger names, which is really, really unusual as opposed to smaller names. I think the upside there is that these names actually, unlike the past, are actually more profitable than what their peers have been back in the day. So there was whole notion that, "Well, AI is a bubble," but then everyone realized, "Wait a minute, they actually have profits associated with that." It may be still a bubble, let's not enough make a decision there today, but they are at least associated with some profit. So I think it's quite interesting to see that play out.

Jim Costello (35:53):

Another parallel to the internet boom era, firms or share prices are rising. They start investing more in the tools that make them productive and in the internet boom era, they were throwing a ton of money into high-end offices. We're going to have the best settings, we're going to have foosball areas, Xbox areas, all kinds of snacks to make that labor that we're focused on much more productive. Similarly, there's a lot of money in the real estate world flowing into the things that go to make these companies that are growing productive, but it's different than offices, it's data centers. There is a wild west type atmosphere there of people trying to get into the data center world and even just tracking the information on it is pretty chaotic. It doesn't come through as easily as the other property sectors at the moment, but it's clearly something that's growing. A lot of folks are asking some questions about it and just trying to figure out how they can follow the AI dollar investments by getting out to the real estate side and getting more of that. But that's been a big move in that sector recently.

Raina Oberoi (37:07):
I just want to add one thing to what Jim was saying was in terms of real estate, right? We saw when I talked about the China equity markets in a sense surprised everyone who rallied in the last quarter, a lot of it was propped up by the real estate reform that China is coming in with saying that, "We don't want the property markets to slide, so we're going to lower mortgage raised, we're going to make it down, payments easier," all these different things. So I think so much of what you're saying, so much of it is interrelated in a sense that real estate could really prop up a market. So I think it's a good point that you bring up here.

Jim Costello (37:38):
China's a different story though. China has, it's been a development market. I've thought about China a lot in terms of Houston and Dallas in the 1970s, there was so much growth and some of the growth, they didn't know how much growth they needed and they built a lot of extra space that they never needed just because the growth was so strong. They figured, "Hey may keep continuing for a bit." And then there was some pain as they adjusted, but they figured out how to get through that. And I've always thought that the Chinese economy is kind of going through something similar. I've met some of these developers. I met a developer who started a company in Shenzhen. Him and eight buddies each owned a shovel. And so they started a construction company and they built it into a multi-billion dollar global behemoth. It's amazing talking with those folks is that transition period, but that transition period in the real estate than how it impacted it's a little bit different there.

Ashley Lester (38:33):
Well, Abdulla, what's the IRR on that show? We're starting to run short on time, but Abdulla, I wanted to check in with you on our other mega trend sort of long-running mega trend for this year, which is climate change. And we've always felt that we need to look to private markets for doing something about this. Abdulla, what are you seeing in terms of private markets? Are they getting moving renewables and if so, for our listeners who after all are primarily interested in making money, are they making money to the extent that they invest in these things?

Abdulla Zaid (39:06):
Absolutely. Let me just quickly comment on the AI and IT boom that that was just discussed in the public market because we see something similar in the private markets. If I can just take one year, which is 2023, and looking into just information technology deals that were closed in 2023, 33% of the deals were in IT in 2023. So this is compared to the share of IT across all holdings, as I mentioned, if you by chance pick three different deals in 2023, 1 of them will be an IT deal. And then looking into AI. Look, if you actually look into companies that describe themselves as AI or artificial intelligence or machine learning or these types of descriptions, we're also seeing more of those deals and most of them are backed up by venture capital funds. I would say even as high as 74% of them are in terms of NAV are backed up by venture capital funds.
(40:01):

Buyout funds is an important player there, but less important than the venture capital funds here. Those are typically smaller companies, which kind of explains that kind of skew. But from a sustainability perspective, it becomes a question on the data security around these AI companies. So we did quick research on looking into, "What is the investment in terms of on data security. Are we seeing the same uptick that we saw in AI?" Those companies are providing that kind of data protection for the AI companies or the rise of AI companies. We haven't seen as much of an uptick. It became more of a flat. So about only 3% of the IT deals were in data security, but those deals were much bigger than the AI company deals. So those were skewed towards some buyout funds versus venture capital funds. I believe the break between was 18% VC to 52% buyout.

Ashley Lester (40:54):
So Abdulla, are you saying that the AI kind of changes that we're seeing are being reflected in direct investments by VC funds, by venture capitalists in small companies that are doing AI directly, but there's not that many big companies yet for buyout firms to buy and they're going into the supporting infrastructure like security?

Abdulla Zaid (41:14):
More in terms of around the question of we're seeing the boom in AI companies, are we seeing a similar boom in data security that provides that kind of data protection covered for the rest of that a lot of our quoting on AI companies? And the answer was that we're not seeing in terms of number of deals, but we're seeing it in terms of the value of deals. And now going back to your original question, which was on another mega trend, which is the energy transition and the climate funds. So I would say I would describe it as an era of green rush since 2020. If we're looking into funds that have climate related names, and those are a subset of old climate funds, but this is a one that are climate named funds and those we see that over 75% of the capitalization that were associated with these funds were raised in the past three years.
(42:00):
You're talking about 2020 to 2023. And this is at the fundraising level. So this is the capital that are raised at the fund level, but if we're talking at the deal level deal making, meaning that these funds have already been raised, now how RGP is deploying that, we have seen also similar surge into specifically renewable assets in terms of deal making the last few years. And when it comes to these funds, as I said, 40% were in renewables. So we're seeing that green rush is happening at the fund level and at the holding level at the same time. If we're comparing it, let's say to investments going to oil and gas, you would see more net exits than net entry compared to renewable. So there has been a lot of capital in this space and renewables versus, let's say, oil and gas. These are different businesses of course different supply chains, but just we're using them as a benchmark to compare the investment appetite toward oil and gas versus renewables over the last few years.

Ashley Lester (42:57):
That's fascinating. So these are pretty hard-nosed investments you're talking about here. These are not sort of latte sipping work [inaudible 00:43:03], and they want to put their money into renewables, is that right?

Abdulla Zaid (43:07):
Absolutely. This is real capital going into the space and it's really not only coming... We're not sure that this is only climate-focused investments. These are also investments coming from financially-focused investors. So those investments for renewables have yielded higher returns over the past few years, let's say 2016. So in 2023, those renewable investments in terms of exits, they yielded higher returns than oil and gas exits and over the same period. So we're talking about more positive returns, gross of fees, but this is also reflecting the capital rush into the space that I just outlined. The exit market was strong. One of the reasons was because there was a lot of capital in the market that supported that kind of strong exit environment. Whereas I mentioned oil and gas, we saw a lot of exits, so there was not as much capital in this space.
(43:58):

One important thing to mention is that a lot of the discussions we're doing on the returns on the capital inflow into renewables is really looking on the demand side of the equation. But it's very important to look at the supply side at some point because now we are at a higher interest rate environment. There is a lot of downward pressure on multiples. We're seeing the downward pressure on even renewable multiples going down as the whole market's multiples going down as well. So this is a time where it becomes an important thing to focus on the margins and see going on there that may push up the multiples. And another driver may be the macroeconomic environment, of course. And the third one is going to be the supply side of renewable projects that could match the rise in capital inflow into the space.

Jim Costello (44:44):
That capital issue on the real estate side, I think about that a lot. The real estate world is one of the biggest carbon emitters just from heating and cooling buildings. And talking with some of these clients is capital's more expensive now to take a oil burner out of an office building in Boston and convert it to all-electric just for a lower carbon cost. They have a hard time doing that where it makes sense for some of these folks if there's a hammer. And I'm told by a local government to have to do that, that's a real challenge. This one client I am friendly with, he always teases me, "None of you understand what it is to run a business. If you give me a subsidy, if you give me a tax break and make it inexpensive for me to put a new system in place, I'm there with it." And it's simple, people respond to economic incentives. If we want some policy change to go that way, some carrots in a few places in addition to sticks would be helpful.

Ashley Lester (45:42):
Fascinating. And this is the magic of financial capitalism, right? Well look, it's been a fascinating conversation as always. Thank you very much, Abdulla, Jim and Raina. Unfortunately, we're way out of time. So for now, we'll have to leave it here and we'll just have to think, "Well, what will next quarter bring? Will we see these new AI models reshaping equity markets further? Will we see them perhaps helping us solve some climate change problems or will we see the further rise of geopolitics with one or two important elections coming up over the next few months?" Well, all these questions and more we will review in October. And until then, happy Northern [inaudible 00:46:18].

Adam Bass (46:21):
That's all for this week. Many thanks from Joe and me to Ashley, Raina, Jim and Abdulla, and to all of you for joining us. For more on the evolution of the five key themes for 2024 read mid-year update found under the research and insights section at msci.com. Until next time, I'm your host Adam Bass, and this is MSCI Perspectives.

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