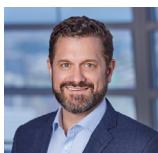




The Active Investor: Mapping the Opportunities in Global Equities



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In this podcast, Lord Abbett Portfolio Manager Ryan Howard discusses his team's approach to investing in global equities, and the role the asset class can play in investment portfolios.

BRIAN FOERSTER: This is Brian Foerster, and welcome to *The Active Investor* podcast, our monthly look at what's happening across asset management, how Lord Abbett's investment leaders are viewing today's markets, and the strategies that can help investors navigate different challenges and opportunities.

In this episode we're talking about equities. And not just U.S. companies but investing all over the world. And with non-U.S. equity markets experiencing a strong year of returns and outperforming U.S. stocks, it's an area that has seen strong interest of late.

And joining us to talk about markets and global equity investing is Ryan Howard, a portfolio manager and managing director here at Lord Abbett. And Ryan's been in the investment industry since 2003 with Lord Abbett, and he's a CFA charter holder. And notably, he leads our top-decile Global Equity Fund. And so welcome, Ryan.

RYAN HOWARD: Hey, Brian, how are you doing? Thanks for having me.

FOERSTER: Great to have you. So, the first question kind of relates to what I just mentioned, that's the outperformance of non-U.S. stocks so far this year. So, what's causing all that?

HOWARD: Yeah, happy to get into that, Brian. So, one of the first things to mention that obviously plays a big part is the depreciation of the [U.S.] dollar on a trade-weighted basis. So, if you look year to date, the dollar has depreciated roughly 10% against other major currencies, which has contributed to that outperformance in dollar terms of foreign indices.

On top of that, you also have some really exciting things starting to happen in other jurisdictions outside of the U.S. And I'll start with Europe. So, when you look at the returns in Europe, the first one you'll notice is the DAX [Index]. So, the DAX is up 20% year-to-date, and up 36% in dollar terms.

And ditto for Spain and Italy, which are also up 20%-plus in local currency terms, and 30%-plus in dollar terms. The story here is

really an interesting one in Europe, where Germany is beginning to loosen its fiscal stance. So, Germany has been a very fiscally conservative place.

And the new government in Germany has committed to €500 billion in investment spending in infrastructure. And then on top of that, Germany has also pursued some policy that allows for defense spending to not be calculated against what they call the debt break.

The debt break is a piece of legislation that limits the fiscal spending capacity of the German government. And all defense spending will be outside of that debt break calculation, which allows them another €400 billion to €450 billion to spend. So, these numbers add up, and the infrastructure package on its own is about 10% of GDP. And when you include the defense spending you get to numbers north of 20% of GDP, which is very material in that economy.

FOERSTER: Right, yeah. You've heard a lot of forecasts for potential international outperformance for 15 years, that valuations were cheap, but it just sort of never really materialized in a sustained way. And now maybe you're seeing a little bit of fundamental tailwinds there that are finally causing it to happen, maybe.

So another topic that you're certainly hearing a lot about today, it's almost hard to miss, is around tariffs. Maybe you could talk a little bit about how you're thinking about tariffs from an investor standpoint, who are the winners and losers, and kind of how you're incorporating those concepts into your portfolio today.

HOWARD: I think as you think through tariffs, you're working with three parties. So, the importer, the exporter, and the consumer. And some combination of those three has to absorb the tariff. So, when we think about it through different industry structures, we can start off with a scenario where we have commoditized producers in Asia selling an undifferentiated good, very fragmented, to an importer base which is highly concentrated.

In that scenario, the importer is going to have a lot of choice. And



they're going to use that choice to force the exporter to take the brunt of the tariff hit. So, in that scenario, the exporter loses. If you flip that example on its head, and we think about something like machine vision, a highly concentrated industry, very specialized, where you've got a couple of producers in Japan which do specialized equipment for it, and a relatively fragmented importer base, that's quite different.

In that scenario, the exporter wins. So, they are going to use the lack of choice that the importer has to ensure that most of that tariff gets pushed on to the importer. And then lastly, we have an example where there's some degree of market power associated with both the importer and the exporter. And in that scenario, both push the burden of that tariff onto the consumer. So that's the bottom-up framework that we use to assess the impact of tariffs.

And the other thing I'll say is we've gone through this analysis several times. So, we started in 2017 with the "Trump 1.0" tariffs and analyzed our company's supply chains to understand where they were producing, to understand how much flexibility they had in their supply chain. And companies were very keen to diversify their supply chain then.

Then came COVID, and the supply chain crisis following COVID. And then again, we got very familiar with our companies' supply chains, and where they were producing, and how much redundancy they had in their supply chains, and how much flexibility the business had to move production.

So that was our second deep dive on supply chains. And then initially, in the run-up to tariffs being implemented, we had, again, another chance to dive in and understand our companies' supply chains a little better. So, we understand them quite well at this point. And then lastly, the competitive advantage framework is one that pushes us towards businesses with market power. And businesses with market power have the ability to shift the burden of that tariff onto others in the value chain.

FOERSTER: Yeah. So, can you give a couple of examples then of maybe winners and losers in that scenario?

HOWARD: Yeah. Happy to do it. So, if you look at a business like Nissan Motor. So, Nissan Motor fell quite a lot when tariffs were announced, and it hasn't recovered. So, auto is a fragmented industry. And it's increasingly fragmented with EV-only players penetrating the market.

The Chinese are beginning to penetrate the market outside of the U.S. So, it's an industry where you're seeing increased fragmentation. There's a lack of market power on the side of OEMs. So, it was rightfully hit when tariffs were announced, and it hasn't been able to recover those losses.

Now, if we look at another example, look at Taiwan Semiconductor Manufacturing, TSMC. So TSMC has a 90% market share at the leading edge for logic semiconductors. So, their customers have very little choice in terms of where they can go for this specialized production. TSMC [share price] is very close to all-time highs and has received wonderfully since the sell-off driven by tariffs. So those are two examples, and framing it through the lens of market power, and very different endpoints in terms of how the businesses have navigated tariffs.

FOERSTER: Yeah. So, you touched on that concept of competitive advantages, and I've often heard you talk about that as sort of a key part of your process. Maybe you could go a little bit further into that and kind of what you mean by that, and the different types of competitive advantages that you and your team look at as you think about what to buy in the portfolio.

HOWARD: Yeah, happy to do that. So, the idea of investing in businesses with competitive advantage is to find businesses that can sustainably earn high returns on capital. And why is that important? So, when you think about the fundamentals of value creation, it's the return on invested capital over your cost of capital.

And the wider that spread is, the more net present value you create, and the more capital you can invest through that spread, the more intrinsic value you're creating as a business. So, it takes us away from looking at intrinsic fair value as a static point, and into something more dynamic where companies are either creating or destroying shareholder value through time.

And we look to consistently be invested in businesses which have the capability to create value over time. So, if you think about a business, capital is a scarce resource in a business. And if you and I both have businesses, and you're earning a return on invested capital of 20%, and I'm earning a return on invested capital of 10%, at some point that starts to matter. And you grow faster than me over time and create more shareholder value.

FOERSTER: So, in terms of, again, the three types that you look at, I know you talked about consumer, producer, and network. Maybe talk a little bit about each of those, maybe some examples of historically what might be emblematic of each of those.

HOWARD: Of course. So, we look for one of three forms of competitive advantage. So, the first would be a consumer advantage. A consumer advantage is a business that's able to sustain a high return on invested capital as a result of a special product. So, there's a lot of pricing power in these business models.

And they begin with high gross margins. So here you can think about the luxury goods space, which is a great example of consumer advantage businesses. So, a business like Hermes, for example. We could start a handbag company tomorrow. We wouldn't have the Birkin bag that they can price in a way that their competitors can't, that new entrants can't. And that special product allows them to earn a very high gross margin, which as it flows down the income statement leads to high net margins and ultimately results in a high return on invested capital.

It's not the only type of competitive advantage. The next would be a producer advantage. So, a producer advantage, it's not so much about the product. It's about the way it's produced. And these types of businesses are generally scale-advantaged businesses or businesses with some economy of scope that allow them to be more efficient than competitors.

So here a great example is Costco. So, the pickles that you get at Costco, that big jar of pickles that's the size of a two-year-old child, there's nothing really all that unique about the pickles. They're the same pickles you could buy at a convenience store or a grocery store.



But what is special is the scale at which Costco is able to provide those pickles. So, they're procuring at enormous scale, which allows them to negotiate great terms of supply and great prices, and they pass those prices onto their customers. Now, different from a consumer advantage business, what you'll notice if you look at the financials of Costco is that Costco doesn't earn high gross margins. They earn about 30% gross margins. But they get to a high return structure, a 30% plus return on invested capital, through a very high asset turnover. So, they're taking an enormous amount of volume and pumping it through a fixed asset base, which gives them a high asset turnover ratio, and allows them to sustain a very high return on invested capital.

So those are two out of the three. And then the last one's a network advantage. So, a network advantage tends to be a bit more prevalent in today's age of internet-based businesses. And really, what a network advantage does is, it creates value by scaling a network larger and larger.

And the way to think about it is if I'm on a network, the bigger the network is, the better it is for me. If you find that situation, there's a good chance there's a network advantage. So here a great example is Uber. So, if you're a driver on Uber what are you looking for?

You're looking for a network with a lot of riders because you don't want to wait a long time after you drop somebody off. And if you're a rider on Uber you're looking for a lot of drivers. So, both cohorts benefit from a larger network. And what happens with network advantage businesses is as they grow and as they scale, you oftentimes see these as winner-take-all or winner-take-most type outcomes, where there just isn't a lot of incentive for a member to leave a scaled network and join an inferior, smaller network.

FOERSTER: Yeah. And in all those cases, it seems like in various ways they're all kind of building up great barriers to entry, right? And it makes it hard for competitors to take that share away from them.

So, another concept I've heard you talk about a lot about in terms of how you invest in your portfolio is how much you focus really just on the individual companies rather than making big bets. And I'm sure you get a lot of questions from potential investors or clients.

Where are you making your big bets around the world? Do you love Japan or are you looking to go heavy on the U.S.? And I know that's not really the big focus of what you do. Seems like you care a lot more about the individual businesses than making those kinds of big bets. Maybe just talk a little bit more about that philosophy and kind of how you incorporate that into your process.

HOWARD: Thanks, it's a great question, Brian. And full disclosure, I love macroeconomics. I was a macroeconomics major in undergrad. And it was always coursework which attracted me, and in a lot of ways kind of shaped my career path into global equities.

But over the course of my career what I've realized is that microeconomics and understanding a business's market position and their competitive moats is really the better way to make money in markets. Particularly when it comes to developed-market multinational businesses, which is most of what we traffic in in the strategy.

So, the other point I would make is that selectivity matters. So, one of the things to understand when you go outside of the U.S. is that at the index level, there are fewer companies that have competitive advantages. So, I'll give you a couple of numbers here to help illustrate that point.

In the S&P 500, about 27% of the businesses earn a return on invested capital of greater than 15%. In the Euro STOXX 600, less than 15% of the index earns a return on invested capital of 15%, and then when you go to Japan in the Nikkei 400, you're looking at a little over 10% of the businesses that earn a return on invested capital above 15%.

So, there are great businesses overseas. There often aren't enough of them to be able to fill an index. So, you're left with this point of "selectivity really matters" when you go overseas. So, one of the things that I think about when I'm selecting my own investments is if you look at a strategy and they have 200 holdings in Japan, I'm here to tell you there aren't 200 companies you want to invest in in Japan.

Our list is 30 to 35 companies, and of those we'll own five to seven of them. So, there are tremendous value-creating businesses outside of the U.S. But selectivity matters when you think about pointing yourself towards those businesses in a repeatable fashion.

FOERSTER: Okay. One last question, and maybe this is more like zooming out. But just kind of thinking about the investors in your strategy, or just kind of investors in general, and how they think about a global portfolio. Some might say, "I want to specialize with an international manager and a domestic manager." Others might want to own a sort of holistic global manager. So maybe just your thoughts on the importance of a global allocation in a client's portfolio.

HOWARD: Yeah. Well, the first thing I would say is that the global opportunity set is the broadest opportunity set. So, to the extent you're going to look for great businesses with competitive advantages, it makes sense to start at the global level and with a manager that can find these businesses in multiple geographies, as opposed to just one.

The second is that there are some currency advantages of investing in a global strategy. So here I think it's worth noting that, again, with the global equity strategy you're getting mostly global businesses, which are dispersed around the world.

So, you're very much getting a revenue composition of the underlying businesses that's global in nature when you think about their currency exposures. And I think that's a particularly interesting thing in this period of time. And we've seen a drop in the [value of the U.S.] dollar. However, if you look at it on a number of metrics, it still does seem a bit extended. For example, in purchasing power parity terms, most of the analysts out there would suggest that the dollar still looks 10% to 20% overvalued. And what could make this change?

This could be growth rates guilty converging a bit more. So, we had a scenario following COVID where growth was the strongest in the U.S., which required more Fed [U.S. Federal Reserve] tightening, which led to higher interest rates in the U.S. relative to other places in the world. And that's now normalizing.



So, if we were to enter a more normalized growth environment with growth rates converging, that's something that could continue to drive dollar weakness. Foreigners have been big buyers of U.S. assets. So, as good as the experience was for a saver and euro terms or yen terms owning U.S. assets, now that currency tailwind that they had following COVID has turned into currency headwind. That selling pressure could, again, put downside pressure on the dollar. So, there's a lot of reasons to want a strategy with a diversified currency basket.

FOERSTER: Yeah, interesting. Well, it's been a very challenging time in terms of the macroeconomy, and yet you've seen equity markets do very well over the past four or five years despite all of the challenges around inflation, now with tariffs.

Certainly, you've seen some markets up over 20% over the last 12 months. Obviously, no predictions of the future, but certainly it has been a very favorable time for equities. And you sometimes hear about other asset classes, trying to get equity-like returns.

And you might say it was a good idea just to stay in equities, as you think about returns and performance over the past few years. And your strategy has certainly done very well. So, thank you for joining us today. I would love to have you back again on the podcast.

HOWARD: Thanks, Brian. I would love to come back again.

Foerster: So, for investors wanting to learn more about Lord Abbett's views on the markets, please visit the insight section of LordAbbett.com. We have a number of papers on global equity investing that touch on a lot of what we discussed here today.

And if you have any comments on today's episode or ideas for future episodes, email podcast@lordabbett.com. We welcome your thoughts and would love to hear from you.

So, we'll leave it there. This has been Brian Foerster with *The Active Investor* podcast. Thank you for listening.



GLOSSARY OF TERMS USED IN THIS BROADCAST

The **asset turnover ratio** formula is equal to net sales divided by the total or average assets of a company. A company with a high asset turnover ratio operates more efficiently compared to competitors with a lower ratio.

Cost of capital is the minimum rate of return or profit a company must earn before generating value.

Gross margin is the percentage of a company's revenue that's retained after direct expenses such as labor and materials have been subtracted.

Intrinsic value represents the price at which investors believe the security should be trading, based on company fundamentals.

The **purchasing power parity (PPP)** exchange rate is the rate at which the currency of one country would have to be converted into that of another country to buy the same amount of goods and services in each country.

Return on invested capital (ROIC) represents the rate of return a company makes on the cash it invests in its business.

Value chain refers to the various business activities and processes involved in creating a product or performing a service.

The **DAX** is a stock market index consisting of the 40 major German blue chip companies trading on the Frankfurt Stock Exchange. It is a total return index.

The **Nikkei 400 Index** is a broad-based equity-market benchmark composed of Japanese companies that are screened for profitability, return on equity and selected based on perceived shareholder-friendly activities.

The **S&P 500® Index** is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

The **STOXX® Europe 600** is a broad measure of the European equity market. With a fixed number of 600 components, the index provides extensive and diversified coverage across 17 countries and 11 industries within Europe's developed economies, representing nearly 90% of the underlying investable market.

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