

**Economic and Market Environment**

As we are writing our quarterly newsletter, the MSCI All Countries World Index is at an all-time high driven mainly by the outstanding performance of the American stock market, which after a strong recovery in 2023 is powering ahead driven by a boom in technology stocks. The posterchild of this boom is **NVIDIA**, the technology leader with a virtual monopoly of artificial intelligence semi-conductors. The Company, which was worth USD8.8bn in 2014, or less than half of the French car company Renault at the time, is now worth close to USD3trillion (or more than the entire market capitalisation of the French CAC40 index today). While the stock might be expensive, its massive run is built on impressive financial results as the Company is expected to generate USD120bn of revenue in 2025 and an astounding USD61bn of free cash-flow. This incredible success story is not unique in US markets as **the outperformance of the S&P500 is not a one stock story**. There are now several multi-trillion dollar market capitalisations, all American and in technology, but also very valuable businesses in traditional sectors like **Eli Lilly** in pharmaceuticals (worth USD855bn) or **EXXON Mobile** in energy (worth USD500bn). We are not here to recommend to our readers to buy any specific stock, but more to analyse the success factors behind the US stock market. We will also try to understand if this outstanding performance is likely to continue over time, and what can be learnt when buying other financial assets.

The pre-eminence of the American capitalist system, while dominant since the end of World War II, was not necessarily a given in 2009. The American stock market had just suffered two of its worst crises in less than a decade with the implosion of the dotcom bubble in the early 2000s and the subprime crisis in 2008, which led to massive bank failures and the bankruptcy of American icons like General Motors. In the prior decade, investing in emerging markets had generated much better returns than owning American stocks and a number of financial observers started to doubt the dynamism of the American stock market.

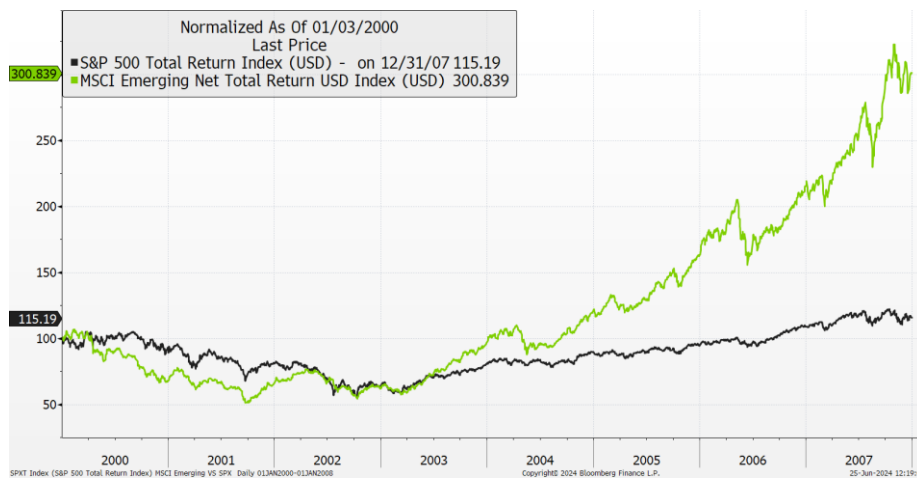


Figure 1 – Performance of the S&P500 (black) compared to the MSCI Emerging Market index (green) between 2000 & 2007- Source: Bloomberg

After two decades of reforms since the 1980s, China had also become a strong contender to become the world's largest economy. Most economists at the time agreed that this was not a question of if but more when, given China's much larger population was now educated and much more productive than before. The Chinese Communist Party had become 'communist' by name only and the Shanghai and Hong Kong stock markets saw a flurry of initial public offerings. The average Chinese citizen has also seen his standard of living improve massively over the past 15 years. Between 2009 and 2022, China's GDP per capita at Purchasing Power Parity (PPP) in current USD more than doubled, growing from USD8,300 to over USD22,000<sup>1</sup>. This also led to significant social improvements with China's Human Development Index increasing from 0.699 in 2009 to 0.768 in 2024<sup>2</sup>.

In contrast, the average American citizen has seen some progress but not nearly as drastic as the improvements in China and has also faced a number of big social crises. The US GDP per capita at PPP improved over 60% between 2009 and 2022 but its human development index deteriorated from 0.956 in 2009 to 0.921 in 2024<sup>3</sup>. In terms of equities, however, the average investor **has done a lot better in the US than in China**, as we can see on the graph below. While both investors started well, the US market tended to be less volatile and has built a massive lead since the beginning of 2021. The US market had a strong rebound post COVID, suffered during the inflation scare in 2022 but then rebounded strongly driven by a stable economy, stabilizing interest rates and a boom in technology stocks. By contrast, the Chinese market appears to have suffered a bad case of long COVID exacerbated by a real estate crisis and confidence issues since 2021.

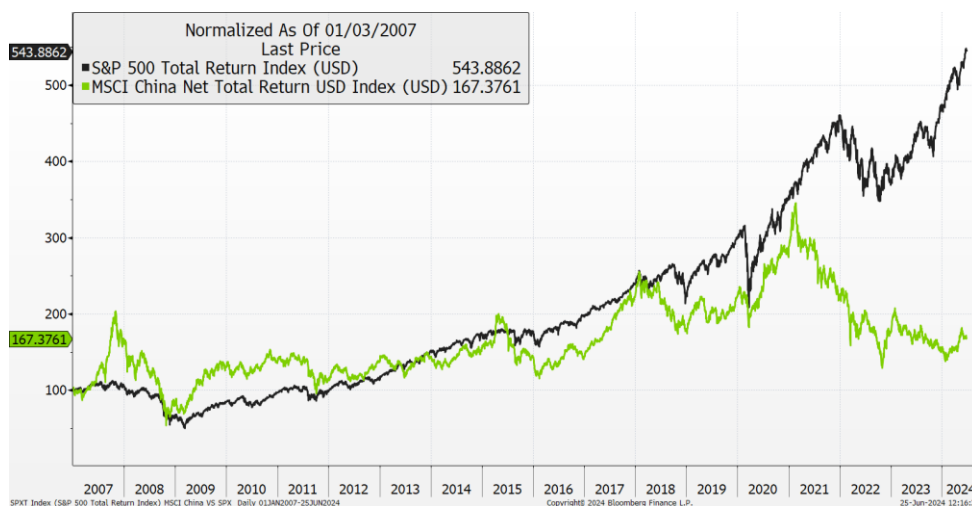


Figure 2 – Performance of the S&P500 (black) compared to the MSCI China Index (green) since 2007 - Source: Bloomberg

From the China-US comparison, we can already see that strong economic growth does not necessarily lead to good stock market returns. Economic growth tends to be a pre-condition for stock market returns, and a bad economy like Japan in the nineties certainly does not help its stock market, but other factors are necessary for a stock market to do well. Through our experience of investing in recent decades, we have come to the conclusion that successful equity investments require **alignment between shareholders and management, good corporate governance** and also an **alignment between the stock market and society as a whole**. If society as a whole has no involvement in the stock market, its performance will have little impact other than on a limited number of shareholders. The worst cases for equity value destruction have tended to come from situations where senior managers' pay & status had **no relation with the long-term stock performance of the company's they managed**. In the past, most Japanese companies tended to have cross-shareholdings to control each other, which limited restructuring and insulated managers from activist investors keen to shake the status-quo. The French government, until recently, was far too involved in the management of large companies and had a revolving door between the government and the management/board of

<sup>1</sup> GDP per capita, PPP (current international \$) - China | Data (worldbank.org)

<sup>2</sup> Rich countries attain record human development, but half of the poorest have gone backwards, finds UN Development Programme | United Nations Development Programme (undp.org)

<sup>3</sup> Measuring America: 10 Years and Counting - Measure of America: A Program of the Social Science Research Council

large companies. The last few years have seen significant improvements, but we can only hope that the ongoing French elections don't destroy that progress. German companies can be heavily influenced by labour unions, which don't necessarily have the same interest as shareholders. It can lead to bloated investment budgets and bad capital allocation. Powerful families in Italy used holding pyramids to control large public companies with small equity stakes potentially at the expense of minorities. South Korea saw some egregious corporate governance practices in public markets. Rich and powerful families facing some of the highest inheritance tax in the OECD (above 50%) used some very creative corporate restructuring to avoid some of these taxes during a succession. The process usually involved an unusually lucrative contract for a company controlled by the heirs of a chaebol (Korean conglomerate), significantly boosting its market capitalization and then merging it with the core company. These machinations cheated the South Korean treasury but also the minorities of the core company. These practices worsened return on capital, distorted capital markets and ultimately resulted in sub-par stock market performance. As we can see on the graph below, the Korean stock market (in green below) delivered some dismal performance compared to the US since 2012 and this was despite having a strong domestic economy and some world-class companies like Hyundai and Samsung.

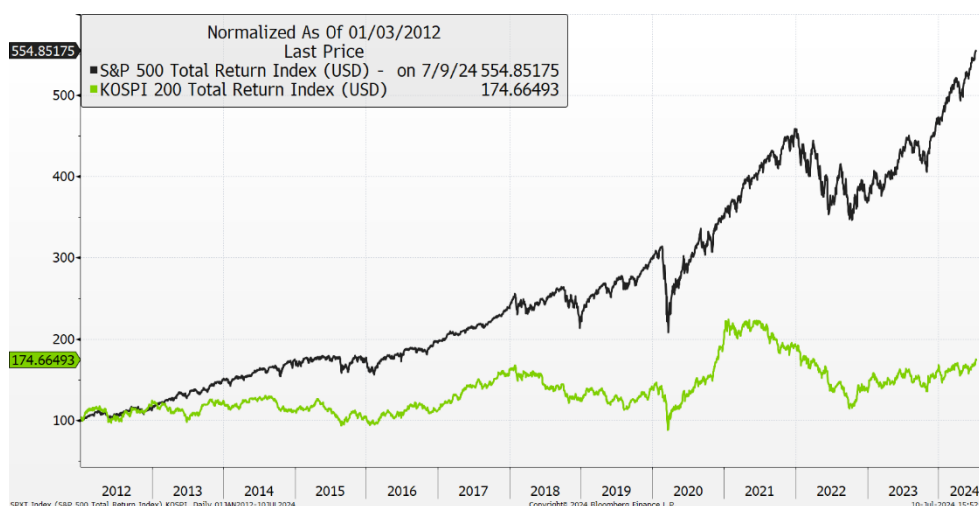


Figure 3 – Performance of the S&P500 (black) compared to the Korean KOSPI 200 (green) since 2007- Source: Bloomberg

American companies can also have corporate governance issues and the system is not without flaws, but a sophisticated regulator, activist funds, large private equity pools, an aggressive justice system and a free press & political system tend to make sure that capital is allocated efficiently and that minority shareholders are not cheated. Another feature of the American system is the **relatively widespread ownership of stocks** in people's portfolio & retirement accounts (401ks). Today, over 60% of American citizens own shares<sup>4</sup>, a relatively constant proportion which never dipped below 50% in recent decades even during the lows after the financial crisis in 2009. More importantly, a large proportion of Americans are dependent on their investments in stocks for their retirement. As a result, the two major political parties in the United States, while they disagree on most things, today broadly support the capitalistic system and the stock market.

One positive development for global investors in recent years has been the broader adoption of some stock market practices. China, which had no stock market before the 1990s, now has very advanced capital markets and some world class companies. Under Xi Jinping though, the government has re-asserted its power, not necessarily in line with the interests of shareholders. The Japanese stock market, which delivered terrible returns between 1990 and 2015, has seen significant improvements in the last few years, with a new focus on return on investment. Combined with the depreciation of the yen, it has led to much better stock market performance. There is a risk that this is only a temporary uptick though as, while the NIKKEI 225 did perform in line with American stocks between 2015 and the end of 2020, it has struggled since then.

<sup>4</sup> <https://www.statista.com/chart/30224/share-of-americans-who-own-stock/>

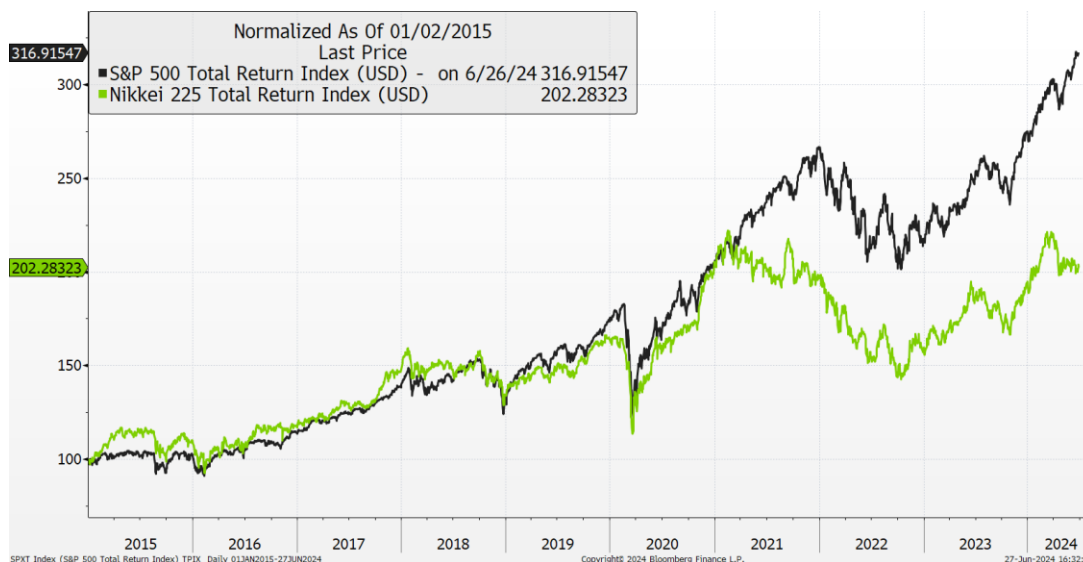


Figure 4 – Performance of the S&P500 (black) compared to the Japanese NIKKEI 225 (green) since 2015- Source: Bloomberg

In conclusion, while the American stock market represents a very large weight in global indexes, it is not necessarily a problem. It benefits from a number of positive factors: a very strong domestic economy, an entrepreneurial culture, an openness to global talent and a culture of value creation for shareholders. Some other countries share some of these characteristics. The current generation of Chinese entrepreneurs, like their American counterparts, share the ability to build exceptional global businesses, but the current Chinese government has questionable feelings about wealth creation and is secretive and authoritarian. Europe benefits from a strong rule of law, a free, open & well-educated society but is ageing, faces strong economic headwinds and is not always friendly to capitalists. All that does not mean that everything is rosy for investors in the United States: the index is heavily concentrated in a few expensive technology stocks, their government deficit is problematic and trade wars - driving inflation up - could re-emerge. We are happy at TreeTop to hold a significant part of our investments in US stocks, but we are also keen to diversify away some of the risks, through our S&P500 Buyback Free Cash Flow strategy, for example, which has more exposure to value stocks. We also continue to find companies outside the United States, which have adopted some of the American best practices, and in some cases can represent tremendous value. In general, a global approach to investment remains our favourite way of maximising potential returns and limiting downside if a region goes through a particularly difficult period<sup>5</sup>.

## Our convictions

Since the set-up of TreeTop Asset Management, we have continuously asked ourselves if we have the right investment approach. We always had a global outlook and tried to find the best investment opportunities wherever they are: Japan equities and bonds in the 1980s, Korean, Chinese and Indian stocks in the last two decades, high conviction fund management and low-cost diversified passive investments more recently. We have also never been afraid to call out bad investments even if it goes against the ‘common perception’. In recent years, we were negative on fixed income & bonds despite these instruments being called ‘safe’ in Europe. They proved anything but safe in 2022 and have significantly underperformed global equities since then. We were, and are, cautious on real estate and private equity, as investors got used to decreasing interest rates, and we are not sure if these asset classes will be able to deliver good returns in an environment of stable or rising interest rates. We have always been positive on the global stock market and the United States is likely to continue to be a terrific destination for investing as we have discussed above<sup>5</sup>. One sector, where we would tread carefully though, are American mega-capitalisation technology stocks. They were the first ones to break the USD1trillion valuation barrier, then the USD2 trillion barrier and now a few are close or above USD3 trillion of market capitalization. USD 3,000,000,000,000 or USD115million of market capitalisation per employee gives us a better sense of how big the valuation numbers are for **NVIDIA**. To put things into perspective for our Belgian

<sup>5</sup> Past performance is no guarantee of future performance

readers, a 15% stock move for **NVIDIA** would add or erase the equivalent of the GDP of Belgium. The current run-up bears some resemblance to the late 1990s, though unlike during the dotcom bubble, where investors were paying far too much for unproven business models, the risk this time is more the ability of these technology companies to grow earnings fast enough and sustain extremely high margins for sustained periods. **TESLA**, a pioneer in electric cars is a good example of what can happen when you pay a lot for an excellent business, but where high expectations don't materialize. The Company initially delivered outstanding earnings growth, as they are a pioneer in a new market, but eventually competition catches up and/or the market growth disappoints leading to a significant stock correction.

Given the increasing weight of American technology behemoths in global indexes, we have been looking over the last two years for investment strategies delivering excellent returns and diversifying this risk away. After an 18 months search, we found the S&P500 Buyback Free Cash Flow index. We refer to our last newsletter, which gives all the details on how the strategy works and why we think it has been able to generate consistently good returns over time. So far this year, the strategy is up over 10%, which while a little lower than the S&P500, is much better than the S&P500 'value' index, which is only up 4%, or the S&P500 ex-technology index, which is up roughly 6% for the year. Interestingly the investment strategy continues to adjust significantly the weights of its investments, depending on the free cashflow metrics and share buyback ratios. At the beginning of the year, the strategy was heavily exposed to American oil & gas refiners and energy stocks. As of its last rebalancing, none of the five largest positions are in energy but instead are:

- **DECKERS OUTDOOR CORP (USD25billion market capitalisation):** an American branded apparel company specializing in outdoor shoes and owner of the UGG brand of luxury sheepskin footwear.
- **WELLS FARGO (USD205billion market capitalisation):** one of the largest retail banks in the United States.
- **ARCHER-DANIELS-MIDLAND (USD30billion market capitalisation):** one of the world's leading agricultural supply chain managers and human and animal nutrition providers in over 190 countries.
- **PAYPAL HOLDINGS (USD61billion market capitalisation):** a technology platform that enables digital & mobile payments on behalf of consumers & merchants.
- **ULTA BEAUTY (USD18billion market capitalisation):** the largest beauty products retailer in the United States.

The commonality of these businesses is that they are able to generate significant free cashflow and their respective management teams believe that their stocks are under-valued and have therefore initiated large stock buybacks. Free cashflow ultimately determines the value of a stock, as it is the cash available to remunerate shareholders after all the costs are incurred including capital investments. Buying companies generating high free cashflow yields (price/free cashflow) is generally attractive, but it does not take into account the future and the sustainability of these cashflows. This where the strategy adds a few more interesting filters, including only buying **American, medium & large capitalisation stocks**. As we have discussed in our previous section, American equity markets tend to generate better returns and be more efficient than other markets. It is also heavily regulated with lower probability of accounting frauds than in other markets. **Share buybacks** are also a key indicator of confidence as it means that the management team believe that the stocks are undervalued.

A key problem in investing is **weightings**, or how much of your total pool you should allocate to a specific investment. Indexes are generally either **market capitalisation weighted**, meaning the largest companies like **Microsoft & NVIDIA** have a larger potential impact on performance, or **equal weighted**, meaning every company has the same weight in an index. Neither method is totally satisfactory, the first one running the risk of allocating a lot of capital to very large and expensive stocks, while the second method risks too much money in small companies. **Truly active investment strategies** (not closeted passive index huggers) try to be better at weighting and have most of the investment pool in names with the highest potential. Nonetheless, active managers suffer from our human limits and can never be totally objective. This is where a quantitative strategy like the S&P500 Buyback Free Cash Flow is interesting as it mixes human judgement with quantitative metrics to hopefully deliver consistent returns over time<sup>6</sup>.

As always, the TreeTop team is always at your disposition for eventual questions and wish you a fruitful investment.

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<sup>6</sup> No guarantee of result or performance.

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*Data & Information as of 28<sup>th</sup> June 2024*

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*Published by TreeTop Asset Management SA, a UCITS Management Company pursuant to the provisions of Chapter 15 of the Law of 17th December 2010 – Registered office at 12 rue Eugène Ruppert L-2453 Luxembourg.*

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