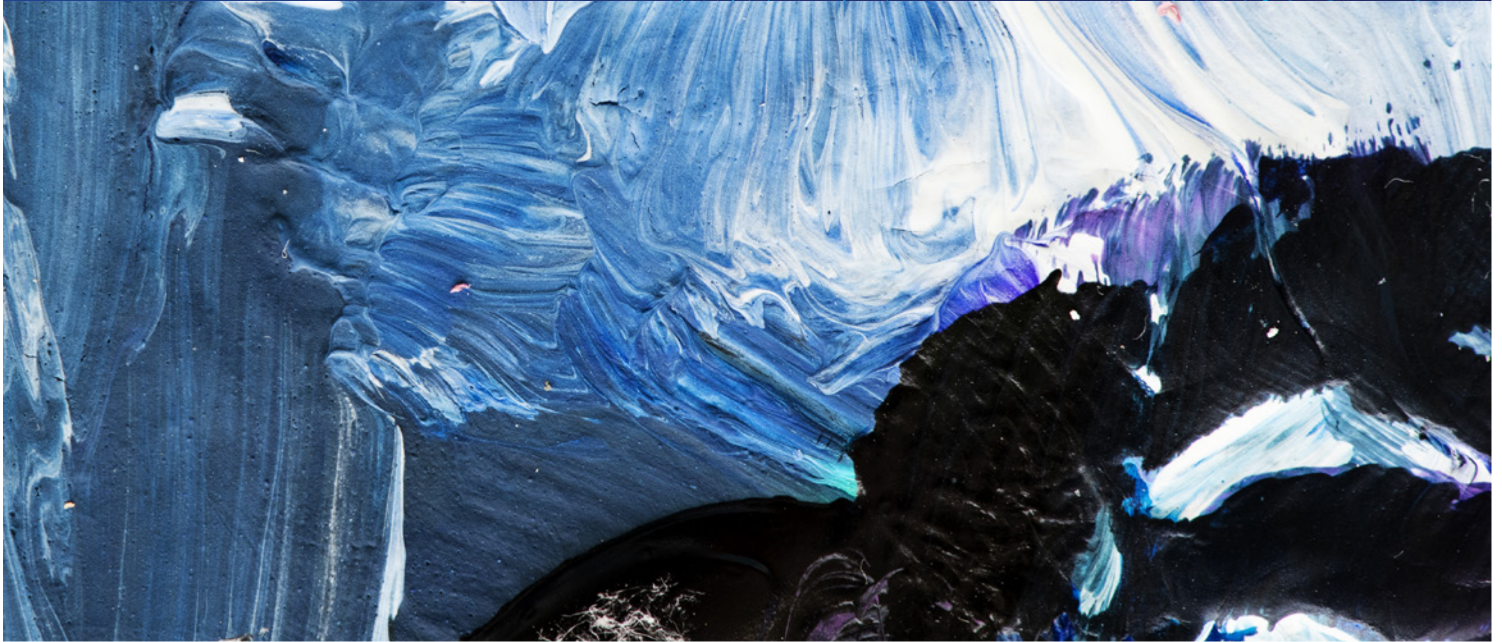


Global Value Team Annual Letter

A 2013 documentary titled *Tim's Vermeer* tells the story of an inventor and art enthusiast—the titular Tim—as he attempts to reverse-engineer *The Music Lesson* by seventeenth-century Dutch master Johannes Vermeer. Tim sought to test a controversial hypothesis circulating in the art world that Vermeer's uncanny ability to capture gradations of light and color in his paintings could be attributed to his use of a *camera obscura*. Vermeer, the theory goes, employed this rudimentary projection device in conjunction with a mirror to provide a steady point of reference as he captured images on his canvas, contributing to the photo-realistic effect of his work.

You're probably wondering what *Tim's Vermeer* has to do with investing. We believe that investors, not unlike Vermeer was purported to have in the documentary, can benefit from having a steady point of reference against which to measure potential opportunities. This was fairly easy 100 years ago under the gold standard when gold was money and by definition could not be diluted; instead of considering the merits of a possible investment in abstraction, those looking to grow their wealth could focus solely on a business' potential to increase in value at a rate faster than gold.

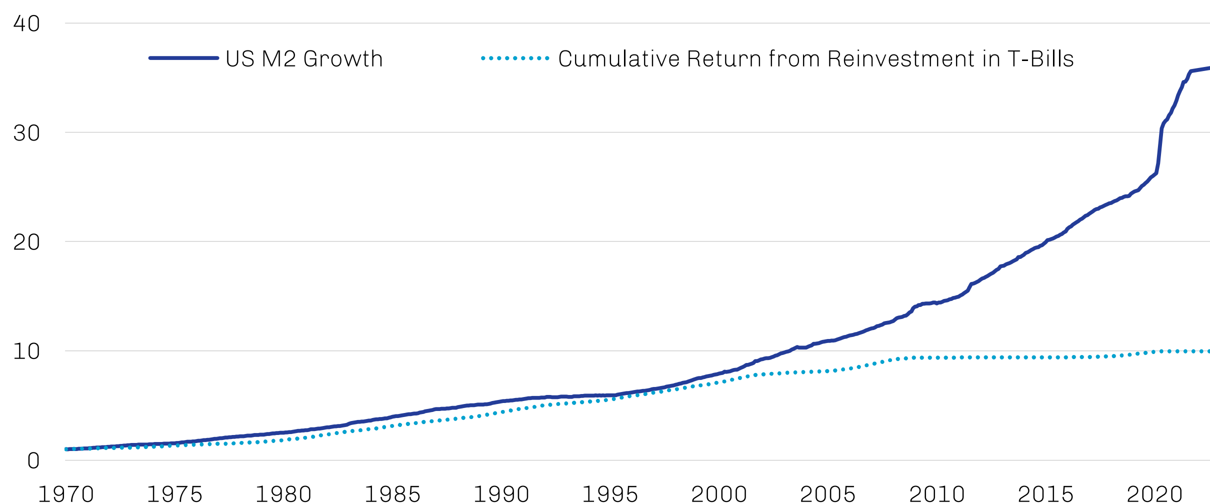
From this perspective, relatively straightforward questions followed. How susceptible is this business to fade in its position, through either asset depletion, competitive pressures, margin compression or multiple contraction? Is the management team capable of redeploying capital such that it generates an adequate return on investment? What is the likelihood that I will need to liquidate this investment at a significant loss during a cyclical crisis?

Since investors in this historical scenario could judge the outcome of their potential investments against the steady alternative of owning gold, they demanded a free cash flow yield of roughly 5% in exchange for the risk posed by equity exposure. Investors knew that if they were not comfortable with the risks of a particular opportunity, they could always keep pace with the value of money by maintaining their wealth in gold. This, of course, is no longer an option in a world of fiat currency; relatively stable money creation has given way to central banks that are able to print as much currency as they deem necessary to meet their economic objectives, with debasement an unavoidable policy byproduct.

Though the classical gold standard came to an end following World War I, money supply growth remained relatively measured under the Bretton Woods system, adopted in 1945, in which global currencies were fixed to the dollar and the dollar was fixed to gold. In 1971, however, the US unilaterally terminated the dollar's convertibility to gold, effectively bringing an end to the Bretton Woods system and converting the dollar to fiat. Without the tether of gold, growth in the aggregate supply of US dollars began to drift higher, as shown in Exhibit 1. A strategy of rolling over Treasury bills at maturity continued to offer investors a riskless way to maintain purchasing power, as gold ownership had in the past, until the early 2000s, at which point this hedge was severed by a sharp acceleration in money supply growth and a structural shift lower in sovereign yields.

Exhibit 1. The Rising Monetary Tide Has Posed Challenges for Investors

January 1970 through December 2021; Index, January 1970 = 1



Source: Haver Analytics, US Department of the Treasury, Bloomberg, First Eagle Investments; data as of December 31, 2021.

Past performance does not guarantee future results.

In other words, investors for the past 20 years or so have been without a "risk-free alternative" that provides a reference point against which to make decisions about potential investments in risky assets. Without the option of riskless preservation of their purchasing power, investors must accept some degree of investment risk just to stay whole. Unfortunately, incremental compensation for all forms of investment risk has been falling steadily.

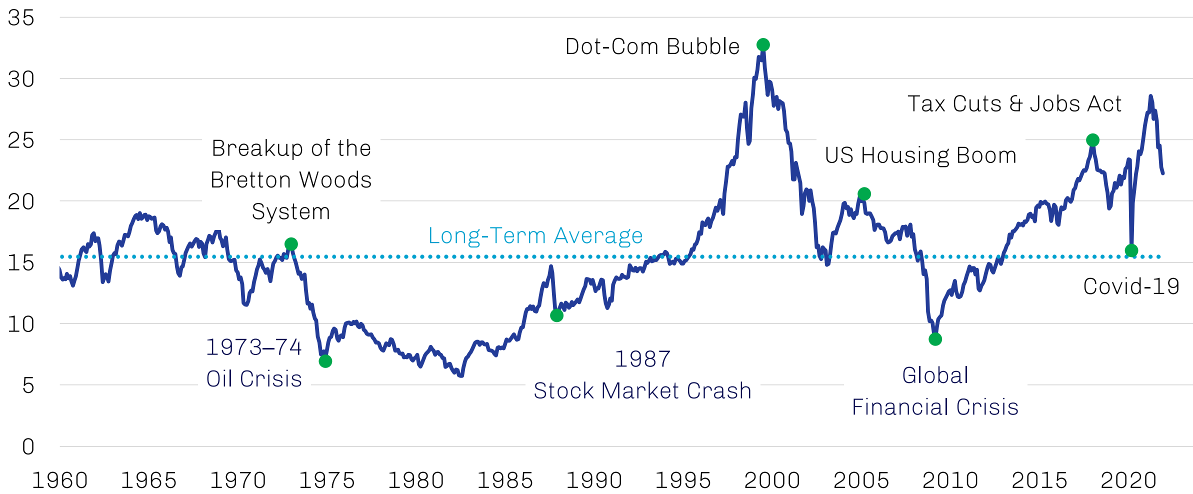
While fixed income investors historically have sought higher yields in securities that offered some combination of duration and/or credit risk, current premia for these risks seem highly unlikely to mitigate the pace of currency degradation. Though off 2020's record trough, yields at the long end of the US Treasury curve remain exceptionally low relative to the past 50 years—and well below the double-digit rate of growth in the money supply. Similarly, credit investors will find yield spreads in both the investment grade and high yield bond markets close to all-time tights.

Equity markets, meanwhile, appear priced for perfection. With the cost of capital at a generational low, it comes as little surprise that valuation multiples are at generational highs in a number of equity indexes. Exhibit 2 tracks the price of the S&P 500 Index relative to CPI-adjusted trailing peak earnings since 1960; as you can see, the late-1990s dot-com bubble was the only other time we saw this metric as high as it is today. High current multiples imply that equity market returns going forward are likely to fall short of the approximately 8% they have averaged over the past century. It also implies that passive exposure to equities is unlikely to offer a premium that keeps pace with money supply growth.

> Without the option of riskless preservation of their purchasing power, investors must accept some degree of investment risk just to stay whole.

Exhibit 2. Rich Current Valuations Are a Threat to Future Returns

Ratio of S&P 500 Price to CPI-Adjusted Trailing Peak Earnings, January 1960 through December 2021



Note: "Covid-19" data point reflects S&P 500 trough on March 23, 2020.
Source: Standard & Poor's; Robert J. Shiller, Yale University; First Eagle Investments; data as of December 31, 2021.

Do Market Imbalances Suggest a Tipping Point Is Near?

Rampant money supply growth, low sovereign rates, tight credit spreads and richly valued equity markets: This scenario presents quite a quandary for investors. But despite markets being expensive overall, we believe there are pockets of value to be found. Take non-US equity markets, for example, as proxied by the MSCI EAFE Index. As shown in Exhibit 3, the price of the MSCI EAFE relative to the S&P 500 currently is less than half the 50-year average. Similar historical extremes also can be seen in the differential between growth and value stocks. With the cost of capital having fallen to a generational low, long-duration cash flow streams—as found in many high-growth stocks—were well positioned for outperformance. The resulting valuation creep of the Russell 1000 Growth Index to the Russell 1000 Value Index, depicted in Exhibit 4, is even greater than it was during the dot-com bubble.

> Historical extremes can be seen in the relative valuations of US versus non-US stocks and growth versus value stocks.

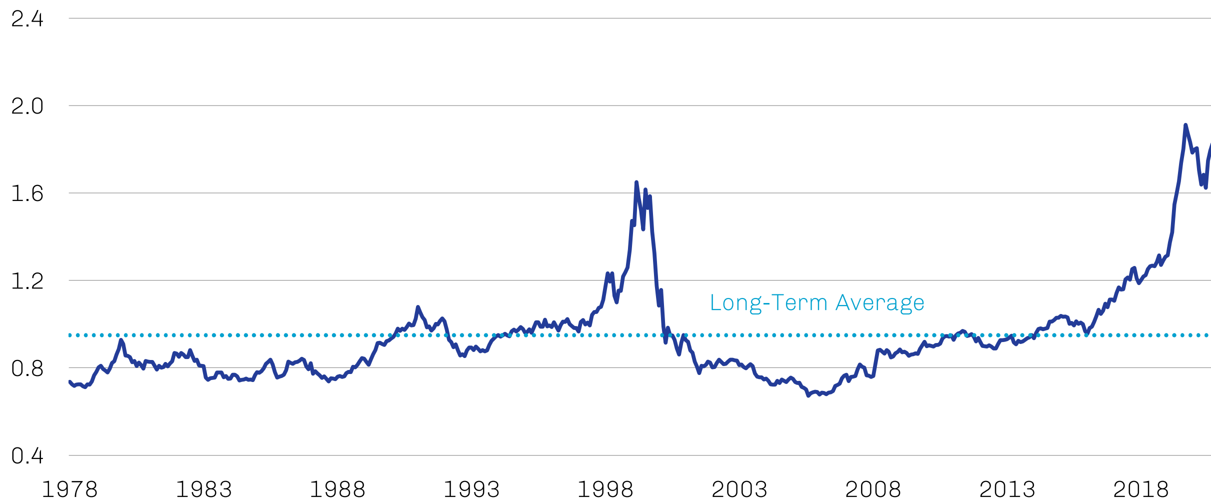
Exhibit 3. Non-US Stocks Have Lagged US Names at a Historical Rate

Price Ratio of MSCI EAFE Index to S&P 500 Index, January 1970 through December 2021

Source: Bloomberg, First Eagle Investments; data as of December 31, 2021.

Exhibit 4. Relative Valuation of Growth to Value Stocks in the US Exceeds Dot-Com-Era Highs

Price Ratio of Russell 1000 Growth Index to Russell 1000 Value Index, January 1978 through December 2021



Source: Bloomberg, First Eagle Investments; data as of December 31, 2021.

One major consequence of these dynamics has been significant concentrations within indexes in certain stocks, sectors and markets. Despite accounting for less than 20% of global economic activity,[1] the US accounted for nearly 70% of the MSCI World Index at year-end, compared to 66% at end-2020 and 48% at end-2009. The index's top 10 stocks—all of which are based in the US and all except two are tech or tech-adjacent—comprise about 20% of the index.[2] Within the US, the five largest stocks in the S&P 500 Index—Apple, Microsoft, Amazon, Tesla and Google (Alphabet Class A and Class C combined)—accounted for 27% of its market capitalization as of year-end.[3] Investors in portfolios benchmarked to the MSCI World—through either passive or active vehicles—are exposed, perhaps unwittingly, to significant stock, sector and country risk.

With global equity markets tilted into an imbalanced state by these market trends, it can be difficult for investors to maintain their focus. But while the US growth universe has been the epicenter of equity market enthusiasm for more than a decade, globally diversified, value-oriented investors—as we are at First Eagle—may take comfort in the belief that the resulting spreads in relative performance may represent a valuation catch-up opportunity for international stocks and value names.

Easy Money Had Investors Looking to the Future

The increasingly complicated investment backdrop may give further hope to prudent investors that have remained true to their investment philosophies and valuation disciplines. Among the most pressing concerns entering 2022 is how markets and consumers react to waning fiscal and monetary stimulus.

The massive fiscal spending that buoyed economies worldwide through the worst of the pandemic's disruptions is slowly fading from view. In the US, for example, government spending at all levels flipped from tailwind to headwind in second quarter 2021 and is expected to continue to represent a drag on growth this year.[4] Meanwhile, a string of elevated inflation prints—well above target in most G20 nations and at multi-decade highs in the US—appears to have forced the hands of policymakers even as the Omicron variant of Covid-19 emerged as a wildcard for global supply and demand trends.[5]

> Among the most pressing concerns entering 2022 is how markets and consumers react to waning fiscal and monetary stimulus.

1. Source: International Monetary Fund; data as of December 31, 2021.
2,3. Source: FactSet; data as of December 31, 2021.
4. Source: Hutchins Center on Fiscal & Monetary Policy, Bureau of Economic Analysis; data as of November 24, 2021.
5. For a closer look at the historical drivers of inflation and the factors at play in the current environment, please see our May 2021 paper, "After the Deluge: Inflationary Impulses in a Post-Covid World."

After months of contending that price pressures were "transitory" in nature and would ease of their own accord, the Fed made a hawkish pivot in late 2021. At its early November meeting, the central bank introduced a plan to taper its asset purchases at a rate that would sunset the program by June 2022; in mid-December, the end date was brought forward to March. A corresponding escalation of concern could be found in the Fed's quarterly rate forecast, as the December dot plot called for three federal funds rate hikes in 2022 after September's report found no consensus for any. To date, the UK has been the only major central bank to hike rates, though a number of emerging markets—including Mexico, Brazil, Chile, Russia and Hungary—have taken action.

> The easy-money environment has been particularly supportive of investment in long-duration growth stocks.

Looking ahead, we see a range of potential scenarios playing out, their likelihoods dictated largely by the aggressiveness of Fed policy, the impact of continued fiscal tightening on household spending and various "animal spirits,"[6] and the reaction of asset prices to slower money supply growth. While we can only speculate on what the future may hold, as an exercise let's consider three possibilities for the investment environment going forward. In the first, the Fed maintains its easy monetary policy, resulting in a weaker dollar, rising nominal interest rates but still-low real rates, and increasing risk premia; in other words, stagflation. The second narrative sees the Fed's efforts to tighten monetary conditions elicit a negative reaction from risk markets, perhaps even accompanied by upward pressure on the dollar, leading financial conditions to tighten sufficiently for the central bank to stop raising rates; this echoes the disinflationary conditions that prevailed through much of the 2010s. A third case involves tighter monetary conditions, higher interest rates and a resilient currency, with hardy animal spirits driving solid earnings growth thereby keeping risk assets from falling despite moderating valuation multiples; we think of this as the "Captain Sully safely landing on the Hudson River" outcome.

The easy-money environment—considered both from post-Covid and post-global financial crisis perspectives—has been particularly supportive of investment in long-duration growth stocks; when interest rates are low, so, too, is the discount rate used to determine the present value of future cash flows, incenting investors to value a company's potential more than its proven achievements. The mathematics of this comparison likely would change alongside the emergence of dynamics that exert upward pressure on discount rates.

All three of these scenarios described above offer some combination of higher interest rates and/or risk premia and, thus, a higher discount rate, which could weigh on the value assigned by the market to the longer-duration cash flow streams typical of growth stocks. Does this imply that we're on the cusp of a great rotation away from the "growthiest" subsegments of the market? Perhaps. But even if we knew that to be the case with 100% certainty, we'd caution against blindly going all-in on the statistically cheapest stocks in the market in anticipation of their rebound. There are many fundamentally challenged companies in the value universe whose low valuations are deserved; likewise, there are many fine companies within the growth universe that are reasonably priced even at current levels given the persistence of their cash flows. Our benchmark-agnostic approach to portfolio construction centers on estimating the intrinsic value of a business based on the particular tangible and intangible attributes that can be expected to drive its cash flows over time, making the idea of value a much broader tent.

Opportunity through Prudence

To us, this potentially transitional moment calls for prudence, a concept that has been out of favor in markets enthralled with mega-cap US stocks on one end and totems of speculative excess—such as earnings-free initial public offerings, special purpose acquisition companies (SPACs), cryptocurrencies and meme stocks—on the other. We've long believed that extrapolating trends is a risky way to invest, especially in an environment in which the cost of capital is at a generational low. We prefer to focus on companies whose valuations are grounded in their current cash flows and rates of intrinsic value growth rather than those based on long-dated, acceleration stories that may be pressured by rising interest rates.

> We've long believed that extrapolating trends is a risky way to invest, especially in an environment in which the cost of capital is at a generational low.

6. "Animal spirits" is a term popularized by John Maynard Keynes to describe the interaction of emotional factors like confidence, optimism and trust that sometimes override quantifiable fundamentals to shape the behaviors of investors and businesses.

Of course, prudence doesn't mean turning a blind eye to the broader trends that have gained steam in recent years and may shape economic activity for decades to come. Instead, it demands that we approach these opportunities from a different angle, often eschewing the market darlings in favor of companies that combine sound business positions—or, even better, an engine to improve their current positions—with modest market expectations as reflected by valuation multiples. While such an approach may result in underperformance during periods of unbridled enthusiasm for risk, we believe the vibrant, all-weather character of our portfolio holdings best positions our clients for the long term.

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For example, while ecommerce was among the primary beneficiaries of Covid-related lockdowns in 2020, its share of total retail sales in the US had been growing throughout the twenty-first century. Though off its peak of 15.7% in second quarter 2020, ecommerce as a percent of retail sales, at a projected 13.0% for third quarter 2021, remains well above pre-pandemic levels, and there are a range of companies across industries that we believe may benefit from continued adoption of online retail, some of which can be purchased without forsaking valuation discipline.[7] We would include C.H. Robinson, North America's largest freight broker, among these companies. As a logistics intermediary, C.H. Robinson links businesses across industries to transportation providers, facilitating deliveries of all sizes, including the less-than-truckload shipping and last-mile delivery services that connect online retailers with their end consumers. Further, the company's asset-light business model—it doesn't own the trucks, train cars or airplanes that do the hauling—allows it to adapt quickly to changes in the pricing environment. The highly cyclical nature of the freight brokerage business is something to keep an eye on, however.

Similarly, the ongoing transition to cloud-based computing services gained speed in the Covid era, as lockdowns had businesses prioritizing scalable, flexible, reliable technology solutions in what had suddenly become a work-from-home world. In a process that began even before the pandemic, Oracle has been migrating its 40 years of database expertise to the cloud to meet the needs of its multinational blue-chip customer base and to compete with the cloud-native providers that have sought to unseat it. Oracle's scale and expertise has enabled it to maintain enviable customer renewal rates in excess of 90% and an annuity-like stream of recurring cash flows based on long-duration service contracts.[8] Though the continued execution of its cloud transformation remains a risk, the company's well-managed balance sheet has enabled it to consistently return cash to its investors through a robust share-buyback program.

The overwhelming success of US names in recent years has somewhat obscured the many compelling investment stories we believe are evident internationally, in both developed and emerging markets. Among developed economies, there's a view of Japan, in particular, as a shadow of its former self given massive public debt, aging demographics and persistent deflationary pressures. And while the country does face challenges, it also is home to some of the world's most innovative companies—like Fanuc—that are changing the face of global manufacturing through the development of computerized numerical control (CNC) machines and other factory automation solutions.

Emerging markets were generally unloved in 2021 after a strong comeback from the 2020 Covid swoon; the MSCI Emerging Markets Index shed about 6% last year, with particular weakness in the second half.[9] Burgeoning global inflation forced a number of emerging markets to hike interest rates over the course of the year even as developed nations remained highly accommodative, an additional headwind in areas already challenged by the persistence of Covid and its variants. We think there may be some earnings latency built up here, which could benefit the cash-flow-generative businesses in our portfolios. This includes beverage companies like Mexico's Fomento Economico Mexicano (FEMSA), a longtime "wish-list" stock we were able to acquire in 2020 as the Covid selloff sent its valuation falling to a level we believed represented a significant discount to our estimate of its intrinsic value. Buoyed by a solid balance sheet, quality management and dominant market positions, companies like FEMSA may benefit from a potential normalization of demand in its core markets. Of course, the continued disruption of demand by Covid-related restrictions remains a risk.

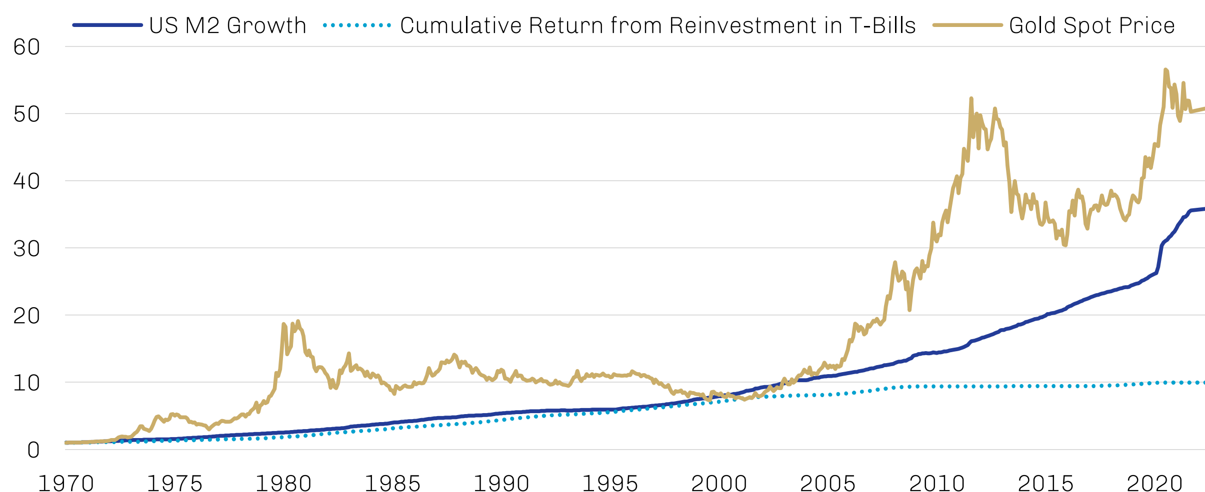
7. Source: US Census Bureau; data as of November 18, 2021.
8. Source: Company reports; data as of September 30, 2021.
9. Source: FactSet; data as of December 31, 2021.

We also hold gold, the reference point of yore, as a potential hedge against adverse market and macro outcomes in a number of our portfolios. Despite significant levels of money supply growth in 2021, the gold price slipped during the year and served as a headwind to portfolio performance. However, we remain confident in its utility. Exhibit 5 depicts gold's price action since it began to trade freely with the demise of the Bretton Woods system in the early 1970s, alongside the growth in the US money supply and the cumulative total return of ongoing reinvestment in Treasury bills. While clearly more volatile than Treasuries, gold historically has been a superior store of wealth for those investors looking to preserve their purchasing power over the long term. Moreover, its price has shifted higher in conjunction with the acceleration of money supply growth in the twenty-first century. Though periods of price underperformance—such as we saw in 2021—are not uncommon, the yellow metal's limited supply growth has benefited portfolios that hold gold and gold-related securities as a potential hedge against ballooning money supply.

Though periods of price underperformance—such as we saw in 2021—are not uncommon, gold's limited supply growth has benefited portfolios that hold gold and gold-related securities as a potential hedge against against ballooning money supply.

Exhibit 5. Gold Prices Historically Have Outpaced Money-Supply Growth

January 1970 through December 2021; Index, January 1970 = 1



Source: Bloomberg, Haver Analytics, Federal Reserve, First Eagle Investments; data as of December 31, 2021.
Past performance does not guarantee future results.

The Eye of the Beholder

In the documentary, Tim ultimately—and painstakingly—produces a reasonable facsimile of *The Music Lesson* despite his lack of formal art training by relying on a system of optical technologies to guide his brushwork. While the methods employed by Vermeer himself remain a mystery, the beauty of the Dutchman's results are undeniable.

Our reference point is the preservation of clients' purchasing power over time.

For the Global Value team, our reference point is the preservation of clients' purchasing power over time. This means that we seek to deliver a long-term rate of return that outpaces the growth of the money supply. We pursue this goal by consistently seeking to own businesses we believe embody scarcity value, complemented in certain portfolios with an allocation to gold-related securities as a potential hedge. While market dynamics for much of the past decade have not usually favored our style of investing, we remain steadfast in our belief that a prudent approach to resilient wealth creation ultimately will produce something we're proud to display.

Global Value Team Update

First Eagle believes that providing growth opportunities for talented individuals and continually reinforcing the strength of our leadership framework best positions our investment teams to execute on behalf of our clients. As such, we were pleased to announce a number of promotions and assignments within the Global Value team earlier in 2021.

Kimball Brooker was promoted to co-head of the Global Value team alongside Matt McLennan. A 12-year veteran of First Eagle, Kimball has worked closely with Matt as the deputy head of Global Value for the past seven years, and his role has evolved significantly over this time as the team has grown in terms of human capital and breadth of capabilities.

Global Value team members—including Matt, Kimball and our other portfolio managers—are first and foremost research analysts. To recognize the sustained contribution of our deep bench of senior analysts and to ensure that we are fully leveraging the diverse perspectives of investment professionals across the Global Value team, we added new portfolio managers to certain strategies and promoted associate portfolio managers in others. We expect that empowering more of our investment professionals with portfolio management responsibility will contribute to our ongoing quest for high-quality investment ideas while also bringing valuable insight to our position-sizing decisions. It also will bolster our mentoring and development efforts across the platform, further strengthening our bench and helping nurture the Global Value team leaders of tomorrow.

- **Manish Gupta** was promoted to portfolio manager of the Global Value strategy from associate portfolio manager.
- **Julien Albertini** was named portfolio manager of the Global Value strategy.
- **Christian Heck** was promoted to portfolio manager of the International Value strategy from associate portfolio manager.
- **Al Barr** was promoted to portfolio manager of the International Value strategy from associate portfolio manager.
- **Mark Wright** was promoted to portfolio manager of the US Value strategy from associate portfolio manager.
- **Idanna Appio** was named portfolio manager of the Global Income strategy.

In our experience, providing growth opportunities for talented individuals and continually reinforcing the strength of our leadership framework best positions our investment teams to deliver prudent stewardship of client assets over the long term. It also enhances our ability to be proactive in addressing identifiable market needs and evolving client preferences as they emerge. Of late, this has included creating portfolios that represent discrete expressions of certain themes already present in our flagship investment strategies—a focus on scarce, durable intangible or physical assets, for example, or environmental, social and governance (ESG) sensitivity.

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Indexes are unmanaged, and one cannot invest directly in an index.

MSCI EAFE Index is an unmanaged total return index, reported in US dollars, based on share prices and reinvested net dividends of approximately 1,100 companies from 22 countries and is not available for purchase.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index designed to measure equity market performance of 23 emerging markets.

MSCI World Index is a widely followed, unmanaged group of stocks from 23 developed markets and is not available for purchase. The index provides total returns in US dollars with net dividends reinvested.

Russell 1000 Growth Index measures the performance of the large-cap growth segment of the US equity universe. It includes those Russell 1000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium-term (two-year) growth and higher sales per share historical growth (five years). The Russell 1000 Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment.

Russell 1000 Value Index measures the performance of the large-cap value segment of the US equity universe. It includes those Russell 1000 companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium-term (two-year) growth and lower sales per share historical growth (five years). The Russell 1000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment.

S&P 500 Index is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the US economy. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 80% coverage of US equities, it is also considered a proxy for the total market.

Risk Disclosures

Gold and gold-related investments present certain risks, including political and economic risks affecting the price of gold and other precious metals, like changes in US or foreign tax, currency or mining laws, increased environmental costs, international monetary and political policies, economic conditions within an individual country, trade imbalances and trade or currency restrictions between countries. The price of gold, in turn, is likely to affect the market prices of securities of companies mining or processing gold, and accordingly, the value of investments in such securities may also be affected. Gold-related investments as a group have not performed as well as the stock market in general during periods when the US dollar is strong, inflation is low and general economic conditions are stable. In addition, returns on gold-related investments have traditionally been more volatile than investments in broader equity or debt markets. Investment in gold and gold-related investments may be speculative and may be subject to greater price volatility than investments in other assets and types of companies.

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All investments involve the risk of loss of principal.

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