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International Equities — Are They Still Worth It?

August 2019

- U.S. stocks have outperformed non-U.S. markets for the last decade, resulting in extended valuations for U.S. companies at a time when earnings are near a cyclical peak.
- This recent outperformance of U.S. equities and their current valuation premia are anomalous based on longer-term evidence.
- Reexamining the case for non-U.S. allocations, we find that non-U.S. markets offer investors attractive valuations as well as potential to reduce risk and add greater active returns.

In 1975, Gary Bergstrom, who would later help found Acadian Asset Management, published a seminal article in the Journal of Portfolio Management, "A New Route to Higher Returns and Lower Risks," that advocated adding international equities to a U.S.-only portfolio to enhance returns and lower volatility.[1] For the following 30 years, the benefits predicted by Bergstrom largely held: a portfolio of both international and U.S. stocks did indeed provide superior return and risk characteristics versus a domestic-only portfolio. In recent years, however, this pattern has faltered as the returns of non-U.S. stocks have lagged, and they have offered little apparent diversification protection. In light of recent experience, we reexamine the case for allocating to non-U.S. equities in a U.S. investment portfolio.

Recent Performance in Context

For most of the last decade, U.S. stocks have outperformed those of other developed countries. Since July 2009, the S&P 500 index has returned 14.7% per year. Over this same period, MSCI EAFE (Europe, Australasia and Far East), a common non-U.S. benchmark index, has returned 7.4% annually in U.S. dollar terms. This outperformance has been driven in part by stronger U.S. economic growth and corporate earnings but also by increasing valuation levels.

Figure 1 compares annual returns for the S&P 500 and MSCI EAFE since 1970, the inception of the EAFE index. If at first glance there appears to be no pattern of long-term dominance of U.S. equities, that is because there is none. Over the last 49 years, U.S. stocks have outperformed 24 times, or just under half the time. This includes the last ten years when the S&P 500 has outperformed seven times and the last five years, during which the S&P outperformed four times. Further, in interpreting those recent returns, it is worth highlighting that nearly a quarter of the gains on the U.S. index have come from the FAANGs (Facebook, Apple, Amazon, Netflix and Google/Alphabet).[2] Despite their impressive track record over this period, most of these firms now face slowing growth and/or increased regulatory restrictions. As a result, we believe that they are unlikely to continue to contribute as strongly to U.S. returns going forward. This could reinforce the historical pattern that when one region strongly outperforms the other, as the U.S. did from 1998 through 2003, the performance gap often subsequently reverts, as EAFE outperformed in the years following.

[1] Gary L. Bergstrom, "A New Route to Higher Returns and Lower Risks," *The Journal of Portfolio Management*, Fall (1975): 30-38.

[2] For illustrative purposes only. This should not be considered a recommendation to buy or sell any security.

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How Expensive are U.S. Stocks?

Accompanying the recent outperformance of U.S. equities has been an expansion of multiples – arguably not a sustainable source of long-term returns. As of June 2019, the Price/Earnings ratio on the S&P 500 was 19.3x, a 16% premium over its average since 1975. (Table 1) In contrast, the P/E of the EAFE index was 15x, a 22% discount over its long-term average. U.S. equities now trade between a 29% and 115% premia to EAFE, well above premia averages since 1975. Put another way, an investor in U.S. equities currently pays nearly a 30% premium per dollar of earnings versus other developed markets. By other value measures, U.S. stocks are even more costly.

Figure 1: S&P 500 and MSCI EAFE Index Annual Returns

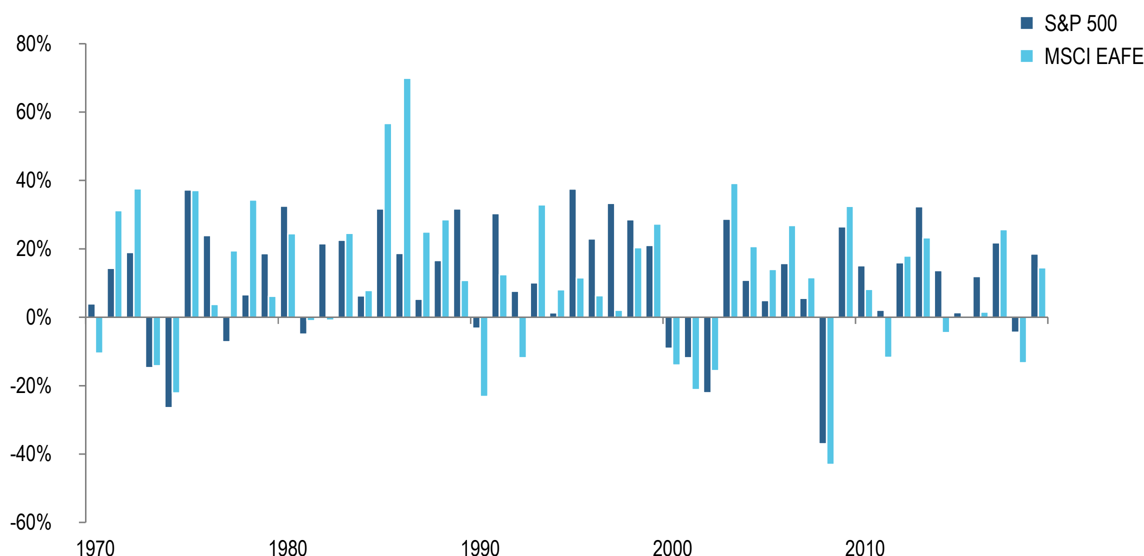

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Table 1: Comparative Valuations

	Price / Earnings	Price / Book	Price / Cash Earnings	Dividend Yield*
Current Valuations				
U.S.	19.3	3.4	13.9	1.9
EAFE	15.0	1.6	9.0	3.4
Averages Since 1975				
U.S.	16.7	2.4	10.0	2.8
EAFE	19.2	1.9	8.1	2.9
Current Premia versus History				
U.S.	16%	44%	39%	33%
EAFE	-22%	-14%	10%	-17%
U.S. Premia vs EAFE				
Current	29%	115%	55%	43%
Avgs Since 1975	-13%	28%	23%	1%

**Sign adjusted on dividend premia for comparability to other ratios*

Benchmarks: S&P 500 and MSCI EAFE. Sources: S&P, MSCI, Bloomberg. Standard and Poor's: Copyright © 2019, Standard & Poor's Financial Services LLC. All rights reserved. MSCI: Copyright MSCI 2019. All Rights Reserved. MSCI. Unpublished. PROPRIETARY TO MSCI. For illustrative purposes only. It is not possible to invest directly in any index. Every investment program has the opportunity for losses as well as profits. Past performance is no guarantee of future results.

Not surprisingly, relative valuations have varied considerably over time. Figure 2 shows how these premia and discounts have evolved. For example, the pattern of U.S. valuation expansion relative to EAFE witnessed over the last 10 years parallels a similar expansion that occurred during the 1990s. Those valuation gaps largely reversed over the following years. Currently, the U.S. P/B premium is the highest in 44 years and P/E, the third highest.

Poor Timing for the U.S.?

Higher valuations would be justified if earnings are expected to grow more quickly than alternatives – in this case, if U.S. companies are expected to grow earnings faster than their non-U.S. counterparts. However, it is far from clear that this is the case. Corporate profitability in the U.S. as a percent of the overall economy is near a 70-year high. At 9.5% of GDP, U.S. corporate profitability is 40% above its long-term average and 60% above the average of major non-U.S. economies. (Figure 3) So not only are U.S. equities currently trading at significant premia relative to their history, as noted above, but the underlying earnings behind those multiples are near a cyclical peak as a percent of GDP. From a timing standpoint, this appears to be a less than ideal combination.

Figure 2: S&P 500 versus MSCI EAFE Valuation Premium

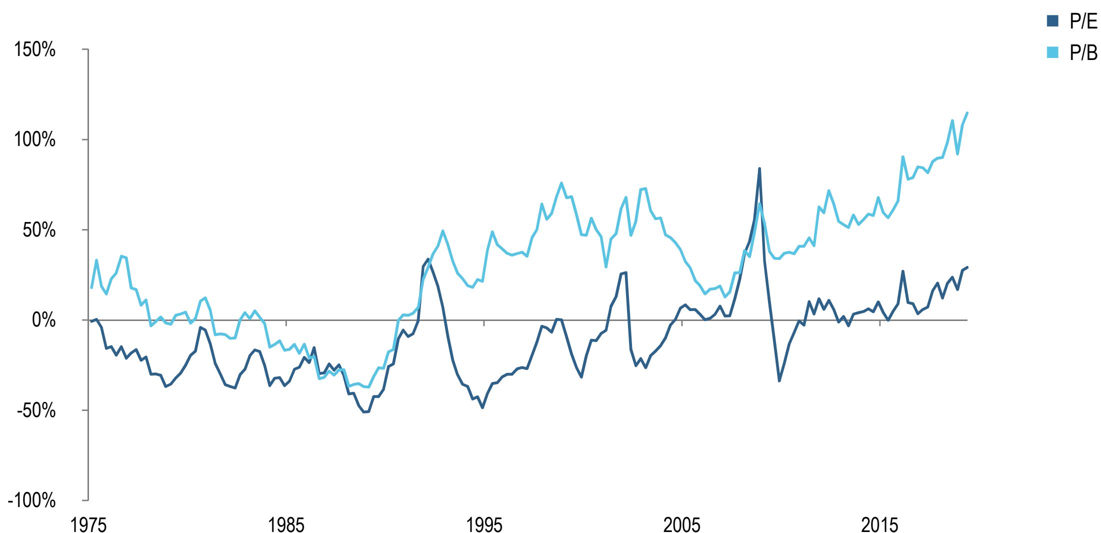

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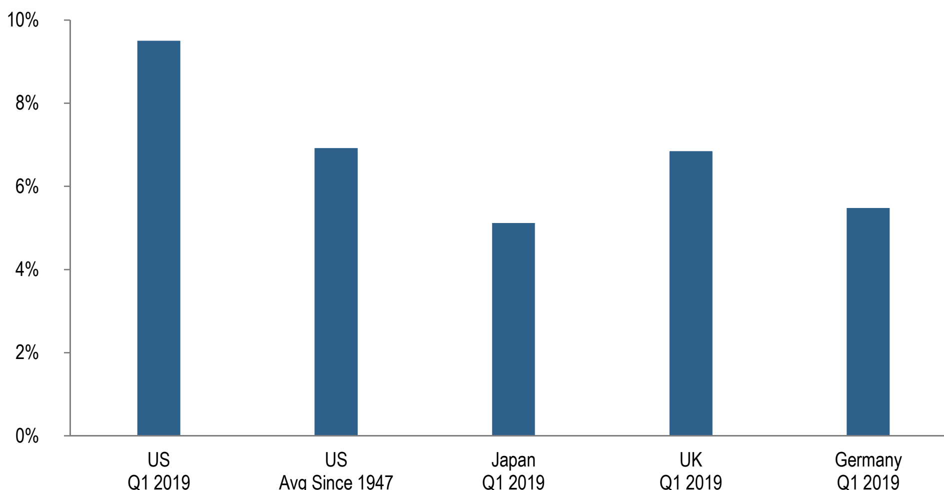
Figure 3: Corporate Profits as Percent of GDP



Sources: OECD, Trading Economics, Federal Reserve Bank of St. Louis. For illustrative purposes only.

Is Diversification Dead?

Since the 1970s, there has generally been a risk reduction benefit to U.S. investors from allocating part of their equity portfolio to non-U.S. stocks. Other developed markets are not perfectly correlated with U.S. returns, which provides some risk reduction versus a domestic-only portfolio. However, the degree of this risk reduction has varied over time. For sample portfolios of 50% EAFE/50% S&P 500 versus S&P 500-only, the mixed portfolio generally had lower volatility from the mid-1970s through the mid-2000s. (Figure 4) Since that time, the mixed portfolio has experienced *higher* total volatility versus a U.S.-only portfolio due to the historically low volatility of U.S. equities. It is worth noting that the diversification benefit from non-U.S. stocks has most recently again entered positive territory, indicating a reduction in risk relative to a U.S.-only portfolio.

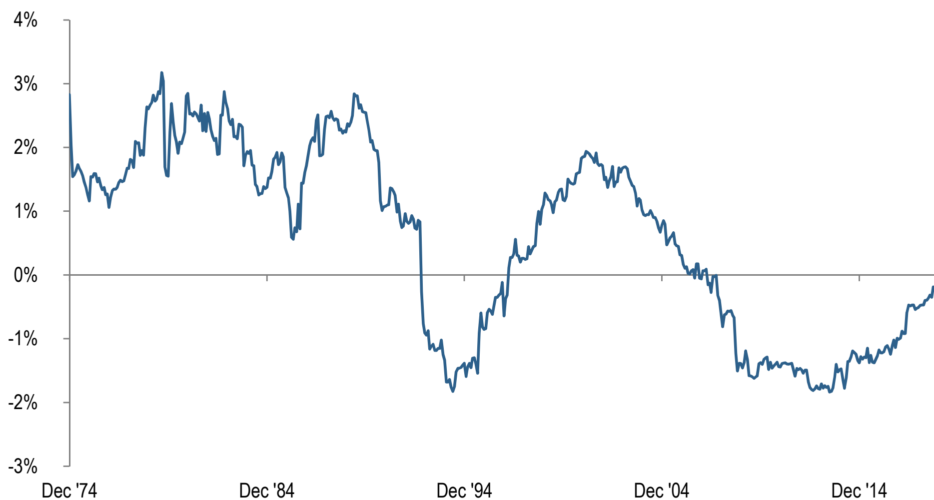
For a U.S. investor, diversification through EAFE exposure has traditionally been framed in geographic terms, capitalizing on differences in economic and earnings cycles and changes in risk premia across countries and regions. However, it is important to consider industry and sector diversification as well. For example, the largest sector in the U.S. index is now Information Technology (IT), at 22%. In contrast, the weight of IT in EAFE is 7%. IT has strongly outperformed in recent years, so to the extent that sectors exhibit cyclicality in earnings and share prices, diversification from this sector could benefit investors over the full market cycle.

Active Returns for Non-U.S. Portfolios

For investors using active management in their portfolios, international equities have typically provided higher active returns than U.S. strategies. Reasons include a greater opportunity for stock selection from the broader investable universe of international stocks. For example, MSCI's EAFE large/mid-cap universe totals 920 companies versus 500 for the S&P. Further, international strategies span a wider range of macro-economic conditions allowing for benefits from active country and regional allocations. Over the last five years, the median active value-added for S&P 500 managers has been -1%/year whereas the median active return for international managers has been +1.3%/year over EAFE. (Table 2)

Figure 4: Risk Reduction: 50% EAFE/50% S&P 500 versus S&P 500

Difference between annualized volatilities over rolling 5-year windows



50%/50% portfolio rebalanced monthly. Negative values indicate higher volatility for 50%/50% mix versus S&P 500-only portfolio.

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Table 2: Active Manager Returns

Five-Year Average Value-Added, Gross of Fees

	US Large Cap vs. S&P 500	EAFE All Cap vs. EAFE
5th Percentile	3.9	5.1
25th Percentile	1.0	2.4
Median	-1.0	1.3
75th Percentile	-2.7	-0.2
95th Percentile	-5.4	-1.9
Observations	951	109

Source: eVestment Alliance. Used with permission. See full eVestment disclosure at end of paper.

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Conclusion

The impressive successes of the U.S. economy and equities over the past decade have led many investors to question the benefits of holding international stocks in their portfolios. But we believe that non-U.S. equities present an opportunity to investors in part *because* they have lagged over the past decade. Evidence for the case includes:

- The likelihood of superior performance versus the U.S. based on historical return patterns
- Further relative return contributions if unprecedented valuation discounts revert to long-term averages
- Portfolio risk reduction based on recent and historic diversification evidence plus superior value-added from active management

Investors often exhibit "recency bias," extrapolating short-term performance well into the future - even if longer-term evidence suggests otherwise. In evaluating non-U.S. versus U.S. stocks today, investors would be wise to recall that in the 1980s, another country significantly outperformed nearly every other equity market in the world: Japan. From January 1980 through December 1989, the MSCI Japan index returned 21% annually in yen terms versus 10% for non-Japanese markets, including the U.S. Returns were driven by a strongly growing economy and export base that contributed to an expansion of valuation multiples. Since then, however, Japanese stocks have generally lagged other developed markets, as growth failed to meet expectations and lofty multiples reverted. Although there are many differences between the Japanese equity market of the 1980s and the U.S. today, that prior experience should still serve as a cautionary tale to investors about relying too much on the recent performance of a single market when making long-term portfolio allocation decisions.

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BIOGRAPHIES

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Brian joined Acadian in 1990. Prior to his current role as senior portfolio manager, he served as director of portfolio management, overseeing portfolio management policy as well as co-director of Research, responsible for developing and applying investment techniques to evaluate markets and securities. Before joining Acadian, Brian worked in systems planning at Bank of New England and as a senior systems analyst at Mars Incorporated. Brian obtained an M.S. in management from MIT and a B.S. in accounting from Lehigh University. He is a CFA charterholder and a member of CFA Society Boston.

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