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PERSPECTIVES
VIEWPOINTS FROM THE ACADIAN TEAM

Opportunity Beyond U.S. Shores

May 2023

- We encourage U.S. investors to look beyond their shores and consider opportunities in international equity markets.
- EAFE and EM equities look appealing relative to the U.S. on a valuation basis. Growthy speculation that has particularly benefited the U.S. has not fully abated. Value stocks look unusually cheap outside of the U.S. and especially in EAFE.
- While the dollar's strength in recent years likely dissuaded some U.S. investors from allocating overseas, that headwind may have ebbed.

For more than a decade after the Global Financial Crisis (GFC), U.S. equities dramatically outperformed international markets. Dating back to 2010, MSCI's U.S. benchmark has delivered an annualized total return more than twice that of EAFE and four times that of EM.[1] That run of dominance left many investors with regret over non-U.S. allocations and, in many cases, an uncomfortable task of defending them.

Nevertheless, we caution investors not to chase this past performance in their allocations. In fact, in present context, we believe international equities look comparatively attractive relative to the U.S. on the basis of valuations. Moreover, an era of dollar appreciation, which likely dissuaded U.S. investors from allocating overseas, may be ending.

Risks of Chasing Past U.S. Performance

Based on the U.S. market's dominant run after the GFC, many investors despaired of being adequately rewarded by foreign holdings and narrowed their focus to the U.S. But such periods of dominance inevitably end, sometimes abruptly.

As a cautionary example, consider Japan in 1990. After five years of spectacular outperformance amid popular narratives anointing the country as the next economic superpower, how many investors predicted—and were willing to put money behind the view—that Japan would massively underperform the global market over the next decade?

Moreover, in an investment industry plagued by short memories, how many investors recall that from 2003 to 2007 EAFE and EM outperformed the U.S. market by over *9% and 22% per annum*, respectively?

Such examples highlight the risks of allowing past performance to over-influence regional allocations.

Figure 1: Valuations — Forward Earnings Yields Minus Short-Term Interest Rates

Data through April 2023

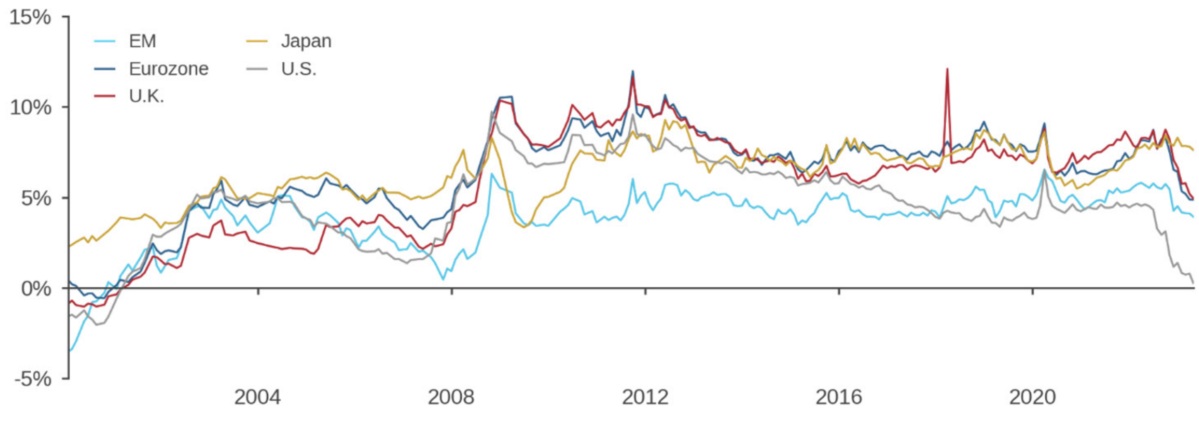


Chart shows 12M forward earnings yields minus the relevant 3M sovereign interest rate (or blend). Data through April 2023. Source: Acadian. For illustrative purposes only.

[1] From 2010 to April 2023, USD returns (net dividends): MSCI USA +346.7%, MSCI EAFE +95.6%, MSCI EM +35.9%.

International Equities: Attractive Valuations

At present, international equities look attractive relative to the U.S. on the basis of valuations. By one measure, the U.S. equity market recently has grown so expensive that the cap-weighted index offers little compensation for bearing risk. As the grey trace in Figure 1 shows, U.S. forward earnings yields are barely above returns on cash, the margin having plunged to its lowest level since the TMT bubble 20 years ago. By contrast, in key EAFE countries and in EM they remain several points above short-term interest rates and unexceptional by historical standards.

Several related factors have contributed to this divergence across geographies. First, U.S. price-to-earnings multiples have expanded apace with other regions even though the Federal Reserve has tightened more aggressively than other central banks.

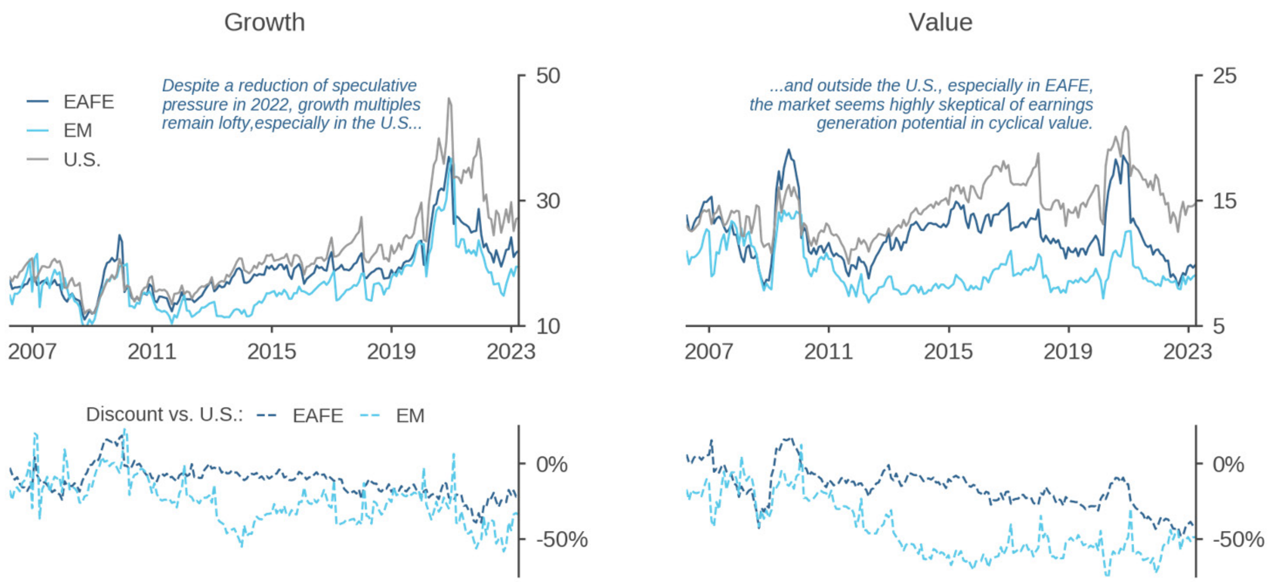
Second, speculative pressures in growthy assets that built up from 2017 to 2021 have not fully abated, despite the 2022 market drawdown. The tech-heavy U.S. was the epicenter of that speculation, a "one-factor bet on growth" that we've chronicled extensively in prior research.[2] Growth multiples there remain lofty both by historical standards and relative to EAFE and EM. (Figure 2, left panel)

Finally, value has become historically cheap in EAFE. Relative to the U.S., the forward P/E for value in EAFE is as low as it has been in at least 15 years. (Figure 2, right panel) The market seems deeply skeptical of earnings generation potential in non-U.S. value stocks, perhaps in part due to the elevated geopolitical uncertainty and comparatively severe deterioration in consumer and business sentiment that was inflicted on Europe by the war in Ukraine.[3]

Given this environment, we believe that the balance of risks favors EAFE and EM allocations relative to the U.S. Moreover, a corollary of this view is that value-oriented investing approaches currently look appealing in those international markets. As evidence, Figure 3 combines the relative expensiveness of growth and cheapness of value from the bottom panels of Figure 2 into a single metric. The chart shows that growth multiples in both EAFE and EM are historically elevated relative to value multiples, which suggests an attractive opportunity set for active strategies that seek to benefit from reversion of mispriced fundamentals.

Figure 2: Price to Forward Earnings Ratios

Data through April 2023



Top charts show price to 12M forward earnings ratios for MSCI USA, EM, and EAFE indexes through April 2023. Bottom charts show discounts of EAFE and EM to the U.S. derived from the valuation ratios shown in the top charts. Source: Acadian based on data from MSCI. MSCI data copyright MSCI 2023. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI. For illustrative purposes only. It is not possible to invest directly in an index.

2 See, for example, Growth Versus Value: End of an Era?, Acadian, November 2022 and International Equities: Timely Appeal, Acadian, February 2022 (available upon request).

3 See European Equities: Making Sense of a Peculiar Era, Acadian, May 2023

Figure 3: Growth to Value Premium in International Markets

Data through April 2023

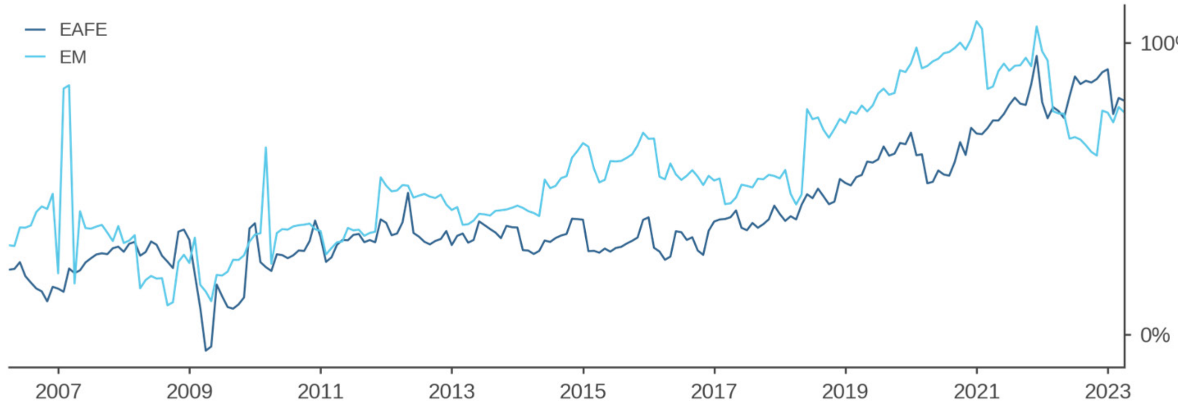


Chart shows the valuation premium based on price to 12M forward earnings ratios for MSCI EAFE and EM growth indexes over the corresponding value indexes. Data through April 2023. Source: Acadian based on data from MSCI. MSCI data copyright MSCI 2023. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI. For illustrative purposes only. It is not possible to invest directly in an index.

Dollar Headwinds Ebbing?

For many years, an appreciating dollar eroded the performance of unhedged overseas equity allocations for U.S. investors. For example, during the first year of the Federal Reserve's aggressive hiking cycle, from March 2022 to February 2023, the dollar's strength reduced unhedged USD EAFE returns by more than 8%.[4] More broadly, as Figure 4 shows, dollar appreciation and its consequent negative impact on international equity returns was for many years a consistent feature of the post-GFC environment.

But we do not see the post-GFC experience as representative of what investors should expect going forward. Returning to the left panel of Figure 4, while USD-based versions of EAFE and EM have trailed local currency versions of the indexes for many holding periods of up to a decade, the bottom bars of the chart show that *since-inception* returns, which start in 2001, are quite similar. Consistent with that observation, the long history of the Real Trade-Weighted Dollar Index (right panel) shows protracted periods of dollar depreciation as well as appreciation. In other words, while dollar appreciation has in recent years eroded USD returns on international investments, it has at other times provided a tailwind.[5]

In fact, the currency headwind has diminished during the first part of 2023. The dollar has softened against other major currencies since late 2022 as the U.S. inflation outlook has cooled, sparking expectations that the Federal Reserve might be closer to the end of its tightening program than the ECB or BOE. Although currency markets remain highly sensitive to macroeconomic data and central bank messaging, our Multi-Asset Strategies team's near-term forecast for the dollar versus other DM currencies remains modestly bearish, reflecting the relative impacts of falling commodity prices, monetary policy, and inflation.

[4] Versus a hypothetical (and uninvestible) "local currency" version of the index. The spread between local and USD index returns is not an indication of the performance impact of hedging foreign currency risk to USD.

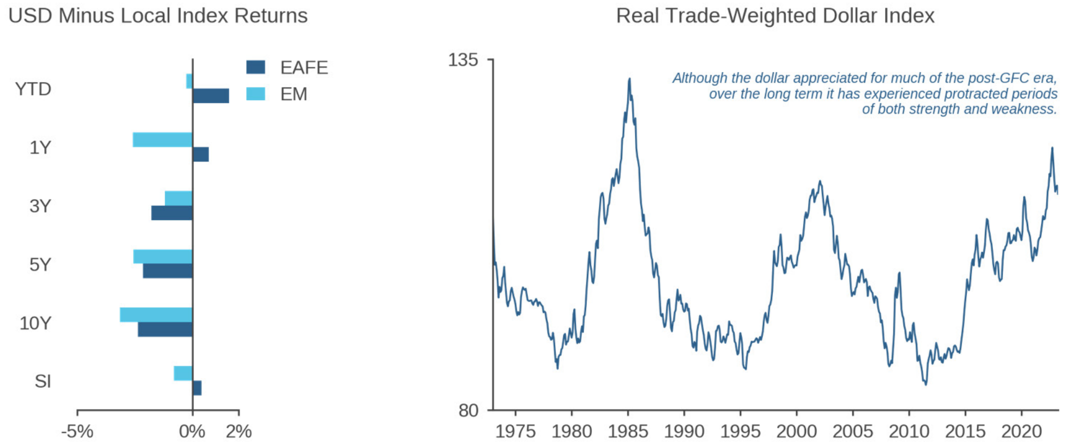
[5] In addition to the empirical observations, there are conceptual reasons to believe that U.S. investors should not expect a material return, either positive or negative, from exposure to other DM currencies. For DM equity portfolios, currency exposure generally only contributes modestly to portfolio risk, and the sign of the covariation between currency and equity returns isn't consistent. As such, investors should not necessarily expect to be compensated for it.

We view EM currencies differently, as "risk assets" that tend to contribute a larger fraction of portfolio risk than in DM. Moreover, currency-equity covariation has generally raised portfolio risk for USD-based EM investors. As such, we would expect that over the long term, the market generally compensates U.S. investors with a premium for bearing risk in EM investments. In other words, theory suggests that EM equity portfolios should generate absolute returns that are higher in USD than in local terms but similar performance on a risk adjusted basis (assuming the risk premium is fair).

For in-depth discussion of currency risk in international equity portfolios and currency hedging considerations, see The Currency Exposure in Your Equity Portfolio: Beyond the Knee-Jerk Response, Acadian, March 2019.

Figure 4: Post-GFC Strength of the U.S. Dollar and its Impact on USD-Based Returns

Data through April 2023



Left panel: Chart shows differences between returns of USD and Local versions of MSCI EAFE and EM Indexes (all on an annualized basis except 2023 year-to-date). Source: Acadian based on data from MSCI. MSCI data copyright MSCI 2023. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI. Right panel: Chart shows splice of U.S. Federal Reserve Trade Weighted Real Broad Dollar Index (2006-present) and Real Broad Dollar Index-Goods Only (1973-2005). Source: Acadian based on data from the Federal Reserve. For illustrative purposes only. It is not possible to invest directly in an index.

Conclusion

Pressure to chase the dominant performance of growthy U.S. equities during the post-GFC environment left some U.S.-based investors underexposed to investment opportunities beyond their shores. With an era of low interest rates apparently at an end, we believe that U.S.-based investors should revisit the case for international equities afresh and value-oriented active approaches in particular.

BIOGRAPHIES

Mark Roemer

SVP, PORTFOLIO MANAGER

Mark joined Acadian in 2017 and is a member of the Managed Volatility Team. Prior to Acadian, he was a portfolio manager and director with Allianz Global Investors, where he managed and conducted research on a number of quantitative equity strategies as part of the firm's systematic team. He previously worked at Barclays Global Investors as a principal and U.S. equity product manager. Mark has an M.S. in engineering from Stanford University in their joint master's program between the College of Engineering and Stanford Business School, an M.S. in finance from the London Business School, and a B.S. in mechanical engineering from Virginia Tech.

Joseph Ritter, CFA

VP, PRODUCT STRATEGIST, EQUITIES

Joe joined Acadian in 2013 and is a member of the Product Strategy Group. Prior to his current role, Joe worked in the Global Client Group supporting new business development efforts and existing client relationships. Prior to joining Acadian, he was an RFP analyst at The Boston Company Asset Management, and previously worked at State Street Global Advisors as well as International Fund Services. Joe holds an M.B.A. and an M.S. in finance from Boston College and earned a B.A. in communications and business administration from the University of Pittsburgh. He is a CFA charterholder and a member of CFA Society Boston.

Seth Weingram, Ph.D.

SVP, DIRECTOR, CLIENT ADVISORY

Seth is Acadian's Director of Client Advisory, a team that produces original research on topical issues in systematic investing and regularly meets with key clients, consultants, and prospects. Seth also chairs Acadian's Editorial Board, driving the firm's thought leadership. Prior to joining Acadian in 2014, Seth held senior roles in equity derivatives trading, research, and strategy at UBS, Barclays Global Investors, and Deutsche Bank. Seth holds a Ph.D. in economics from Stanford University and a B.A. in economics from the University of Chicago.

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