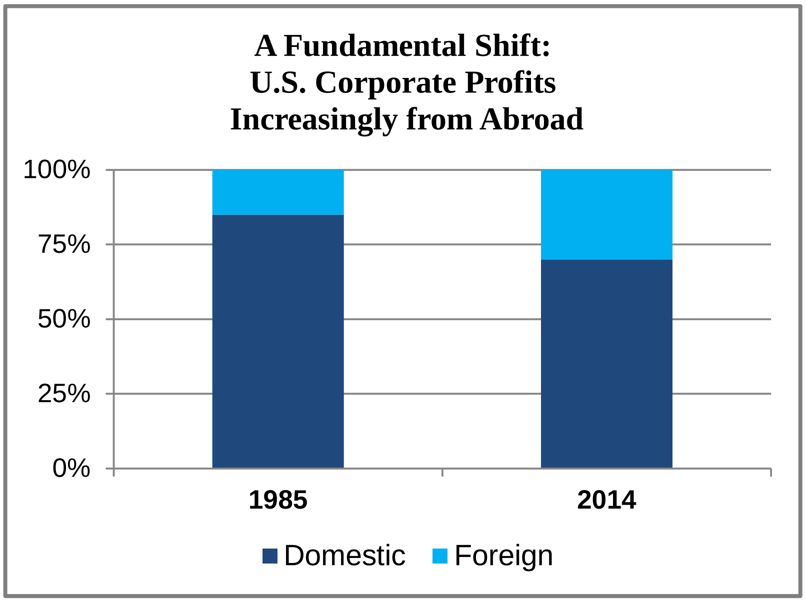
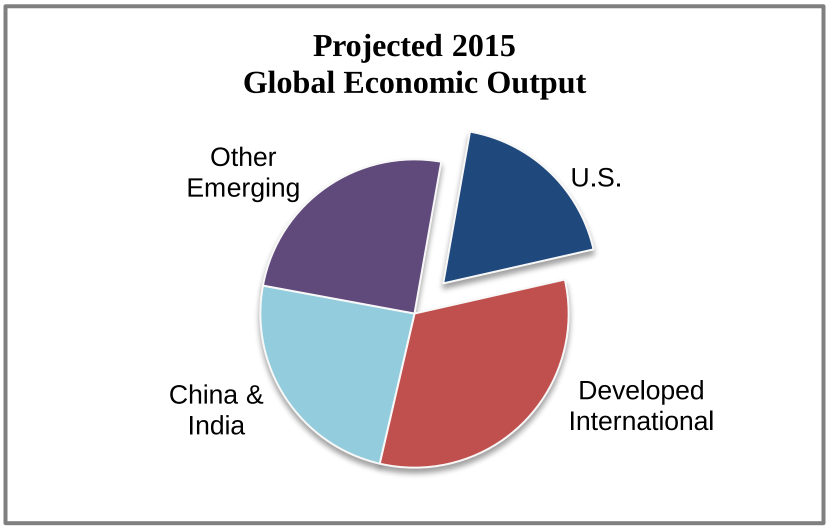
Going Global: The Case for International Stocks

In four of the past five years, investors who owned a globally diversified equity portfolio lagged behind the U.S. S&P 500 index, often by a significant margin. This stretch of underperformance has naturally called into question the value of global diversification versus a U.S.-only approach. While it would be challenging to convince anyone that it was actually good for them to own international stocks over the past few years, we do believe the case for long-term global diversification remains intact. In this month's MAInsights, we will explain why investors should continue to think global from a long-term, strategic perspective and why we believe there is a near-term, tactical case to be made for international equities as well.

Over the past several decades, the world has become increasingly "globalized" from an economic, cultural, and political standpoint, due in large part to increases in global trade and foreign direct investment, technological advances (namely, the internet), and the growing integration of capital and labor markets. One consequence of this globalization has been that countries and companies can no longer compete by only paying attention to the dynamics within their own borders, but instead must consider their advantages, disadvantages, opportunities, and threats on a global scale. As a result, many of the largest companies in the world have recognized that entering new international markets can be the surest way to sustain their growth rates over time. In fact, over the past 30 years, foreign profits as a share of total U.S. corporate profits has grown from less than 15% in 1985 to more than 30% in 2014. With companies continuing to look abroad for opportunities to expand, we expect this trend to remain in place for the foreseeable future.



Our point in setting the context in this way is to frame the idea of global equity investing in the same way U.S. businesses view their own opportunity sets. The U.S. equity market on its own accounts for 51% of the total global equity market capitalization, with developed international markets (such as the U.K., continental Europe, and Japan) and emerging markets (such as China, India, and Brazil) comprising 38% and 11%, respectively. In addition, the international markets are projected to supply over 80% of the global economic output in 2015, with over 50% produced by the emerging markets alone. Therefore, if an investor were to simply focus on the U.S. market, they would limit their opportunity set to roughly half of the global equity market and just 20% of the world's economic production! Of course, with roughly 30% of U.S. corporate profits derived from overseas, the case could be made that investing in U.S. multinationals provides the same exposure to international markets without all the hassle. But in our view, this strategy would restrict an investor from owning some of the best companies in the world like Nestle (Switzerland), Toyota (Japan), Samsung (South Korea), Siemens (Germany), and other companies that are directly exposed to the unique, secular trends in the international markets. For these reasons, just as U.S. businesses continue to think global, we believe U.S. investors should do the same, with a strategic, long-term international equity allocation.



While we believe investors should *always* include international stocks within their equity allocations, we also think international markets are especially attractive today from a tactical standpoint. Following several years of underperformance versus the U.S., many international markets appear set to outperform on the basis of more accommodative monetary policies, improving competitive positions from cheap currencies, better earnings outlooks, and more attractive valuations than here in the U.S. To be fair, the U.S. economy is currently on firmer footing than the rest of the world, but strong fundamentals do not necessarily equate to a strong stock market, particularly in this era of unprecedented central bank easing. In fact, we have found the opposite to be true in recent years as asset prices have responded most favorably to economies that are nearing a trough, receiving central bank support, and about to recover. In the same way, we believe the European and Japanese markets, aided by central bank quantitative easing, are set to outperform in the near term simply because they are in the very early stages of an economic and earnings recovery. For example, while U.S. earnings are now 12% above their 2007/2008 peak, Europe's projected earnings for the next twelve months are still 27% below their prior peak. While the current valuation of Europe at 16 times earnings (compared to 17 times earnings in the U.S.) does not appear overly cheap, the fact that earnings are still at depressed levels means that any profit recovery from here will make the current entry point look that much cheaper down the road.

Our positive outlook on the emerging markets is based on different factors than the developed world and is more likely to play out over a longer time frame. Cyclical challenges related to the slowdown in China and weakness in commodity prices could continue to weigh on many emerging economies, but we believe this has already been priced into the markets to a large degree. Now, with attractive valuations, contained inflation, a recovering developed world, and positive structural reforms taking place in several countries, we expect these markets to begin to make up ground. Longer term, we have even more confidence in the emerging markets based on the urbanization trends taking place and the rise of the middle class consumer in these markets. For perspective, according to JPMorgan, a projected **five million households will move from the countryside to the city in both China and India *every year* for the next ten years**. This type of urbanization movement occurring in the two most populous countries at the same time is unique to human history and will be a very powerful driver of global demand for goods and services. In our view, investors need to be positioning to capitalize on this exciting opportunity.

After increasing our weighting to international markets earlier this year, we are currently targeting up to 30% of equity portfolios to be invested into the international markets, which we believe is on the high-end of most U.S. investor portfolios, but still less than their representation in the global equity market. Within this allocation, we are roughly evenly split between the developed and emerging markets, with a particular emphasis on the Southeast Asian markets where a growing consumer base is benefitting from lower commodity prices and inflation. So far in 2015, our international allocation has been additive to portfolio returns, as the developed MSCI EAFE Index (up 9.2%) as MSCI Emerging Markets Index (up 9.6%) have outperformed the S&P 500 Index (up 1.9%) by a significant margin through April 30th. If our tactical views described above prove correct, this shift in fortunes for the international markets may just be getting started.

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