STATERA
ASSET MANAGEMENT

Commentary: May 2017

COMFORTING NUMBERS

Experts agree: What tomorrow holds no one knows. Most experts, anyway. As we discussed last month, some folks appreciate more, some less, of the volatility that comes with an unknowable tomorrow. Still, market history has shown ways one can reduce the overall level of risk for a given level of return. A foundational tenet of our approach to investing, enhancing diversification, is one method to deploy while seeking to dampen the impacts of uncertainty in our day-to-day investment experience and potentially increase total return. For us, that means not only buying myriad U.S. stocks of all sizes and sectors. We also can seek diversity overseas. After a long spell of U.S. equity market outperformance, however, the chorus of investment isolationists has grown larger, their refrain louder. Nonetheless, while domestic stocks and bonds are likely to remain the core of our holdings for the foreseeable future, we continue to believe there are benefits to come from global-minded investing.

Not Without Risk

So why not look beyond the States for investment diversification? Truth be told, there are additional risks and costs to owning stocks and bonds traded in other countries. The following is by no means an exhaustive list, but one that includes some of the more relevant issues.

First, owning securities in other countries may come with additional costs, including greater transaction fees and taxes. Second, most foreign markets are neither as large, nor as liquid as those in the United States. Troubled times, therefore, may bring more dramatic downside vis-a-vis the U.S. markets. On a similar note, international markets may be more vulnerable to internal economic, political and social volatility.

Furthermore, the relative movements of currencies also are part of the equation. As we add international stocks and bonds to the mix, we increase currency risk in the portfolio. Total returns for securities denominated in other currencies carry the gains and losses of the securities themselves, in addition to the relative change in those other currencies versus the U.S. dollar.

Given those extra costs and risks, let’s consider the opposite question: Why should one look beyond the States for investment diversification? We think the answer is that the potential benefits warrant at least some exposure abroad.

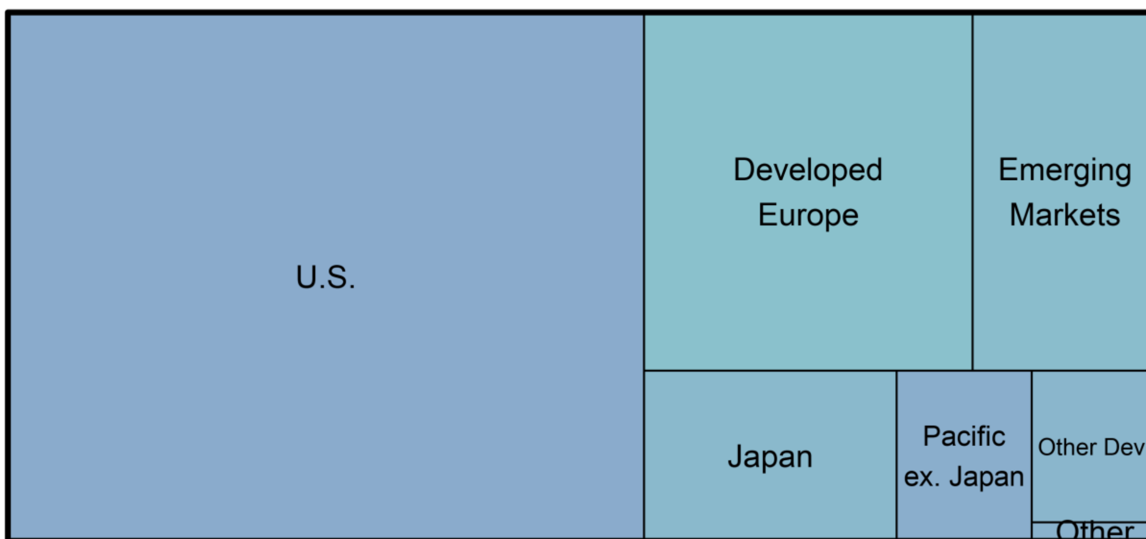
It’s a Big, Big World

We believe diversification sits at the core of most any proper approach to investing. Diversification potentially limits the negative impact that losses among individual stocks and bonds will have on portfolio performance.

Likewise, diversification may enhance the chance that the portfolio will hold substantial gainers. From the standpoint of intuition alone, then, we might choose to boost diversity through exposure to international investments.

Compellingly, it's a great, big world of investing out there. By latest count, shown in Figure 1, U.S.-traded equities comprise a bit more than 55% of global equity market capitalization. Put differently, nearly half of the global equity market exists outside of the United States. Choosing not to invest globally is leaving a substantial amount of potential diversification on the table.

Figure 1: Composition of Global Equity Market Capitalization



Estimate as of 04.30.17. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from MSCI via Bloomberg

Enhancing the draw, equity markets around the world continue to present a greater number of new investment opportunities to U.S. investors, if first-quarter initial public offering (IPO) data are any indication. According to integrated professional services firm EY, 369 companies raised $33.7 billion listing their shares on an exchange for the first time, reaching the highest level of first-quarter activity since Q1 2007. Companies from the Asia-Pacific region comprised 70% of the company total, garnering 48% of the proceeds. This increased dynamism in global equity markets further boosts support for international equity investments, in our view.

More Small, More Value

As an additional thread of support for global diversification, readers might consider our preference for certain characteristics, such as Size and Value, in stocks. Even though research has found several such "factors" to be potentially indicative of relatively stronger long-term returns, we cannot know when, even if, either or both Size and/or Value–or any other factors for that matter–will augment performance versus our benchmarks over any specific time. Looking abroad might increase the potential that the characteristics are finding relative support.

As a reminder, we "tilt" portfolios in favor of these factors, rather that limiting our portfolios to exposures that solely express those characteristics. That way our portfolios may find incrementally greater benefit when outperformance comes, while not falling too far off the benchmark when it does not. In following that thinking, the greater the acceptance of risk, the stronger the tilt toward favored factors. As noted in prior commentaries, we believe we maximize the potential of finding outperforming Value stocks by owning as many as possible. We do not believe that thinking should stop at our borders, so we tilt globally as well.

It's Getting Easier

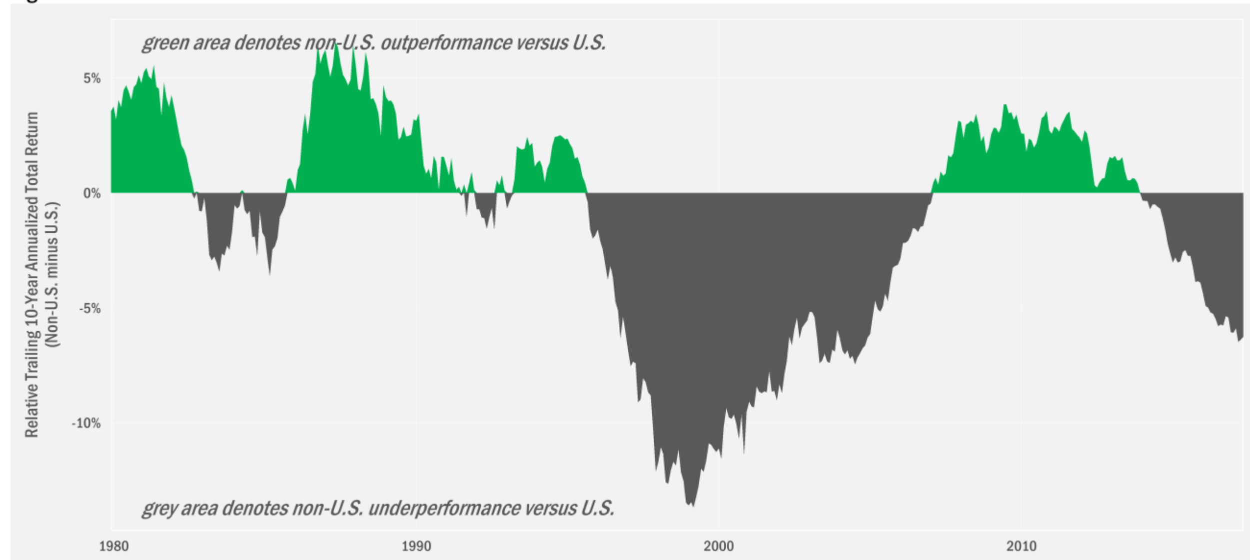
Used to be, prior to the advent of electronic trading and low-cost mutual funds and ETFs, that trading-related friction often was seen as limiting the potential benefits of incremental diversification. This was particularly true of international investments, which once were entirely unavailable to U.S. investors, but which now are accessible in myriad low-cost constructions. With a substantial amount of trading-related friction having been eased through the ongoing evolution of the investment industry (the advent of ETFs having had a particularly notable impact), we find we much more easily and efficiently can boost the diversity of holdings within our portfolios.

Rubber Meets Road

The obvious question, then, is what's been the benefit of global exposures to portfolio risk and return. The answer, when derived from shorter-term returns abroad, unfortunately has not been greatly supportive of non-U.S. equity exposures. However, the long-term view still generally supports our take on portfolio construction.

We can look to the past 47+ years of returns to see what we mean. In Figure 2, we have charted relative trailing 10-year annualized total returns, meaning we took the compounded average annual return of non-U.S. markets and subtracted the same series reflecting the U.S. market. A higher number means international stocks outperformed the U.S. market. We see that the U.S. equity market has outperformed non-U.S. markets by this metric since the end of 2013. And the margin was not insubstantial. In the 10 years ended April 30, the S&P 500 turned in an annualized 7.2% gain, versus 0.9% for the MSCI World ex-USA Index. Of course, one would have been better off from a total-return standpoint having invested solely in the U.S. equity market.

Figure 2: Relative Total Return of International Versus U.S. Stocks



From 12.31.69 to 04.30.17. MSCI World ex USA Index (net div.) minus S&P 500 Index. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all of the invested capital. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

But hindsight is always 20/20. And, outperformance has not been a rule. This same chart shows that just about half the time, non-U.S. markets have outperformed over 10-year periods since the end of the Sixties. That historical probability lends weight to the posture that international exposure can boost overall portfolio returns. And though we cannot be sure that domestic outperformance will not continue, our Value-minded stance leaves us more open to the possibility that the next ten years might see relatively better gains among international stocks. In other words, we see reason for maintaining exposures to globally diversified equity portfolios, even as we remind readers that timing the markets is nothing like timing the tides.

Long-Term View

Combining the diversification-driven potential for an overall reduction in risk with potentially enhanced long-term returns, we generally seek to include international stocks in our portfolios. In a fashion similar to our approach to factor tilts, we incrementally boost international exposure toward the market-neutral allocation (meaning owning global stocks in the same proportion as their respective weights in the global portfolio) as we add more equity to the portfolio. This approach accepts that more risk-averse investors may find greater comfort in having a larger portion of their portfolios invested in domestic stocks and bonds.

Founded in our belief in broad diversification and supported by an expectation of longer-term benefit from some manner of international exposure in our portfolios, we continue to believe long-term rewards can be found by an investment opportunity set that reaches beyond the U.S. As always, we invite readers to reach out to your Advisors for a deeper discussion of the international exposures in our portfolios and the broader asset allocation we maintain to ensure we have matched prospective risk and return with long-term investment plans.

Important Information

Investing involves risks. Past performance is not indicative of future results.

Diversification does not ensure profit or protect against loss.

One cannot invest directly in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio.

The S&P 500 Index represents 500 of the largest U.S. companies by market capitalization.

The MSCI World ex USA Index captures large- and mid-cap equity representation across 22 of 23 Developed Markets, excluding the United States.

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