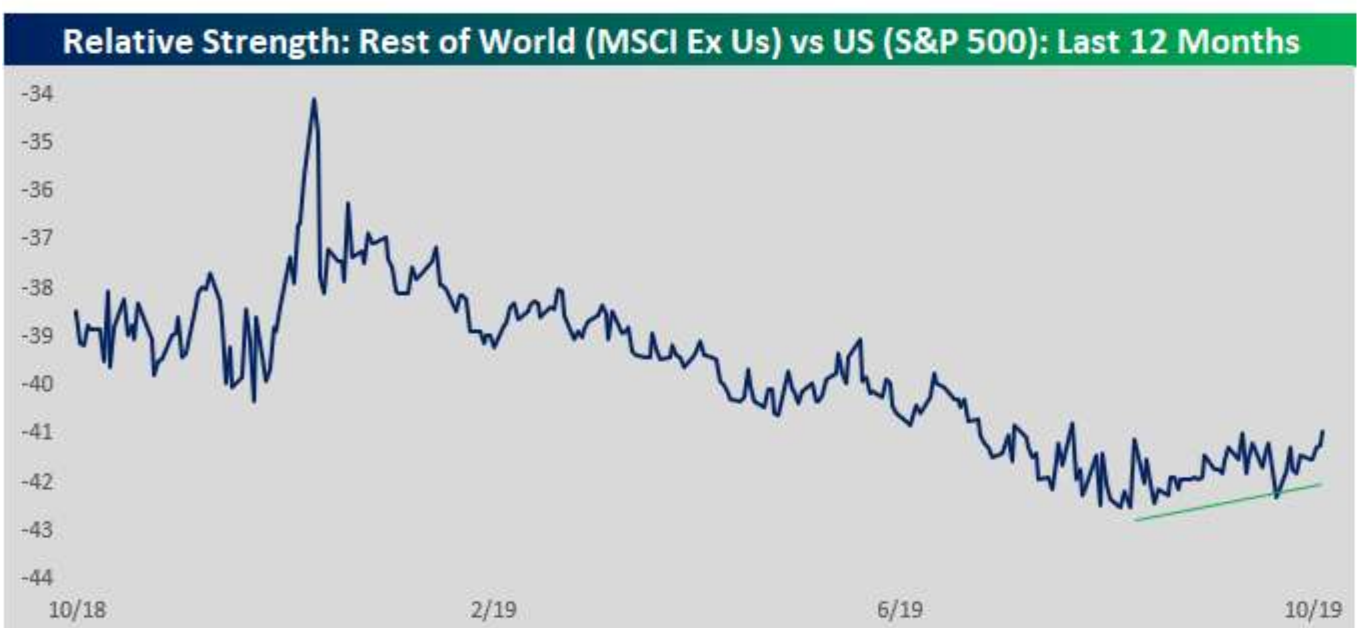
Moving Abroad?

Fri, Oct 18, 2019

While the title may suggest it, this isn't a political post geared towards Democrats who can't stand President Trump or Republicans fearing the prospect of a President Warren or Sanders. What we're talking about here is what could be early signs of a break in the nearly decade long trend of international stocks underperforming equities in the United States. The first chart below shows a long-term look at the relative strength of the MSCI Ex-US Index versus the S&P 500 going back to 1999. When the line is rising, it indicates outperformance on the part of international stocks (ROW), and when it is falling, US equities are outperforming.



While the first several years of this century were dominated by outperformance on the part of international stocks at the expense of the S&P 500, that trend reversed with the Global Financial Crisis as international stocks had given up all of their outperformance by 2012, and then continued to lag going forward. The lower chart shows a closer look at the relative strength between the two indices over the last year. Here, it has been mostly more of the same. Outside of a brief surge during the Q4 market rout late last year, ROW has underperformed the S&P 500 for pretty much all of 2019. That is up until recently. Since late August, the relative strength line of the ROW has actually been drifting higher. Granted, it's not a major shift at this point, but you have to start somewhere, and as of now ROW's relative strength is near a four-month high.

From Morningstar:

Investing Close to Home Is Overrated

Foreign stocks have an important role to play.

Alex Bryan, CFA
Oct 18, 2019

Most U.S. investors have a bias toward U.S. stocks. If the relative value of assets invested in U.S.-listed mutual funds and exchange-traded funds is any indication, the average U.S. investor allocated about 24% to foreign-stock funds and 76% to U.S.-stock funds at the end of June 2019 (this excludes sector and global funds). In contrast, U.S. stocks represented about 45% of the FTSE Global All Cap Index. It isn't necessary to eliminate this bias toward U.S. stocks to reap the diversification benefits that foreign stocks offer. That said, foreign stocks should represent a considerable portion of most investors' portfolios.

Home bias isn't unique to U.S. investors, and it's understandable. Domestic stocks tend to have less currency risk than foreign stocks, which tends to make them slightly less volatile and more appealing, as most investors' expenditures are predominately in their home currency. And investors are generally more familiar with local stocks, which can make owning them feel more comfortable. But a heavy bias toward U.S. stocks can hurt diversification and is often based on misconceptions.

Misconceptions
1. There's sufficient diversification at home.
Business is global. Large U.S. companies, like their foreign counterparts, do business all over the world. This may create the impression that U.S. stocks offer sufficient global diversification and that it isn't necessary to invest in foreign-listed stocks. But that's misleading.

While most large U.S. stocks represent multinational firms, U.S. stocks tend to have significantly greater exposure to the U.S. market than their foreign-listed counterparts. Morningstar data suggests that the holdings of Vanguard S&P 500 ETF (VOO) generated 62% of their revenue in the United States, as shown in Exhibit 1. The corresponding value for Vanguard Total International Stock ETF (VXUS) was 15%. This suggests adding foreign-listed stocks to a U.S.-stock portfolio can better diversify local market risk.

Small-cap stocks tend to generate a greater portion of their revenue from their local markets than large-cap stocks. So, Vanguard Total Stock Market ETF (VTI), which includes U.S. stocks of all sizes, has slightly greater revenue exposure to the U.S. market than VOO.

Exhibit 1 Revenue Exposure by Region (%)

	U.S.	Europe	Asia Pacific	Canada	EM	Unclassified
Vanguard S&P 500 ETF VOO	62.06	12.87	6.43	1.92	16.65	0.08
Vanguard Total Stock Market ETF VTI	64.80	11.94	5.95	1.85	15.27	0.19
Vanguard Small-Cap ETF VB	77.60	7.91	3.57	1.50	8.98	0.43
Vanguard Total International Stock ETF VXUS	15.47	22.74	22.56	4.51	33.58	1.13
Vanguard FTSE All-Wld ex-US SmCp ETF VSS	11.40	27.85	26.14	7.53	25.86	1.23

Source: Morningstar Direct. Data as of June 2019.

2. The U.S. is a good place to do business, and that should lead to strong stock market performance.
The U.S. has a lot going for it, so it may be attractive to some that U.S. stocks still generate most of their sales in the U.S. It has strong shareholder protections, a more-favorable regulatory environment, and better-developed capital markets than many other countries, making it easier to fire workers when appropriate, start new businesses, and innovate. That’s good for business, but it’s not news to anyone. Market prices should already reflect this information, so it isn’t sufficient to generate strong stock-market performance.

Unexpected changes in the quality of the business environment in the markets where firms operate are more likely to influence their stock prices than differences in the level of quality across markets. It’s not clear that the U.S. will surprise on the upside more than other markets.

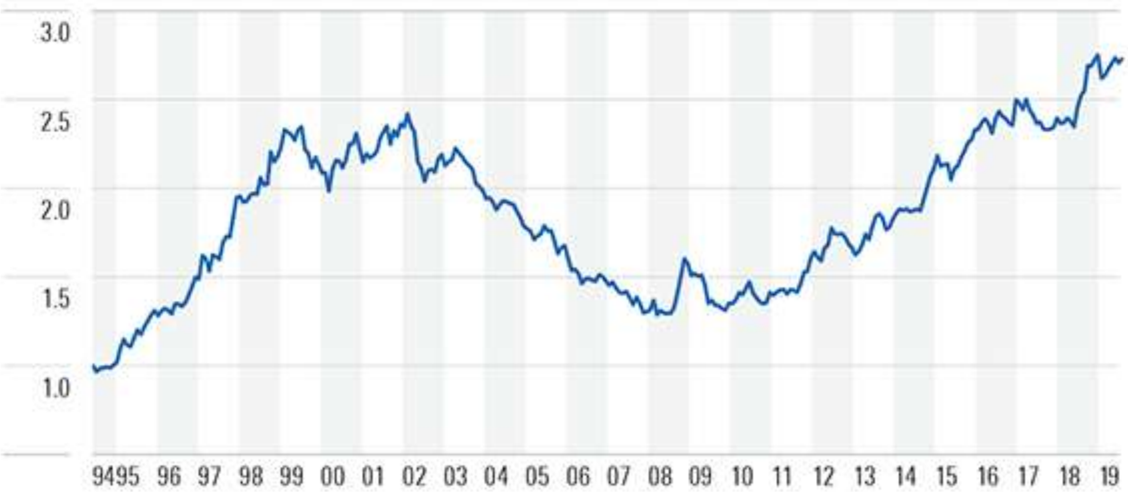
3. The U.S. market will likely outperform foreign stock markets.
The U.S. has been among the world’s best-performing stock markets in recent decades, but that doesn’t necessarily mean it will continue to be in the future. From January 1995 through June 2019, the MSCI USA Index’s return ranked seventh out of 49 single-country indexes, beating the MSCI ACWI ex USA Index by a whopping 4.3 percentage points annually. This strong showing partially owed to differences in sector weightings. More-favorable stock exposure also helped, as did the strong performance of the U.S. dollar against other currencies.

However, there’s little to suggest the U.S. market will continue to outperform foreign stocks over the long term. It may, or may not. The dollar could just as easily lag foreign currencies, and the technology and healthcare sector tilts that helped the U.S. market’s performance in the past could work against it in the future.

If anything, the higher valuations the U.S. stock market currently sports suggest it may have lower expected returns than foreign stocks. That said, differences in sector composition and accounting standards contribute to this valuation gap, which may distort the comparison.

The bottom line is that U.S. stocks are not destined to outperform, and there have been plenty of times when they haven’t, as Exhibit 2 shows. While the MSCI USA Index beat the MSCI ACWI ex USA Index from June 1994 through June 2019 by 4.33 percentage points annually, it lagged in 34% of the rolling three-year periods during that time. Most notably, it underperformed by 9.4 percentage points annually from February 2002 through May 2008. It’s tough to predict when foreign stocks will outperform, but maintaining a strategic allocation to them can help diversify risk.

Exhibit 2 Relative Wealth (MSCI USA Index/MSCI ACWI Ex USA Index)

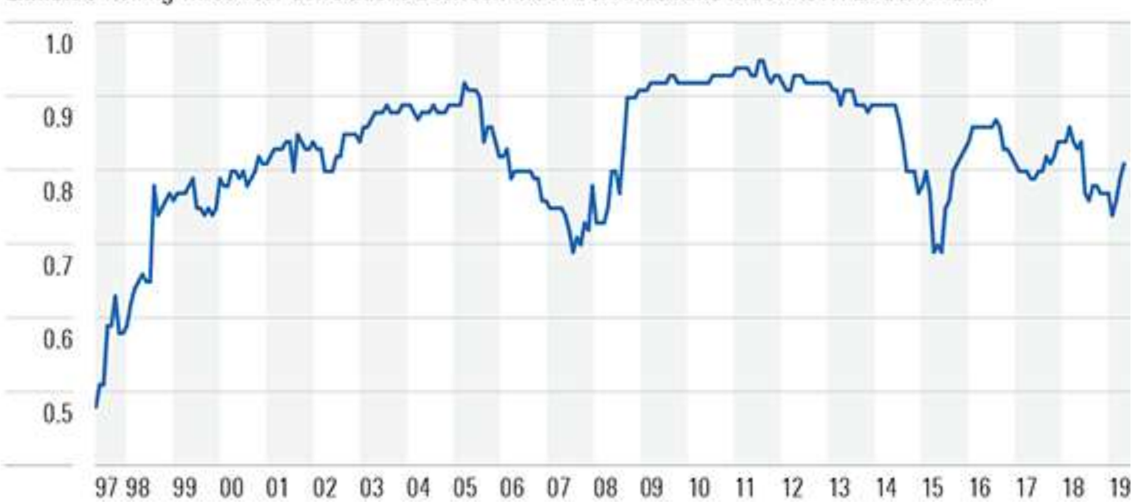


Source: Morningstar Direct. Data as of June 2019.

Diversification Potential

While it's clear that foreign stocks can diversify a U.S.-centric portfolio, the magnitude of that benefit has changed over time. Exhibit 3 shows that correlations between U.S. and foreign stocks climbed in the 1990s and early 2000s, as the world became more integrated. They fell in the years leading up to the global financial crisis before spiking, and remained elevated in the years that followed. These correlations have fallen in recent years, suggesting that the diversification benefits of owning foreign stocks have improved, but they will probably never return to the lower levels they exhibited in the 20th century.

Exhibit 3 Rolling Three-Year Correlations Between MSCI USA Index and MSCI ACWI Ex USA Index



Source: Morningstar Direct. Data as of June 2019.

Because U.S. and foreign stocks aren't perfectly correlated, adding foreign stocks to a U.S.-centric portfolio shouldn't significantly increase portfolio volatility, despite their higher stand-alone volatility. For example, from January 2000 through June 2019, a portfolio with a 33% allocation to the MSCI ACWI ex USA Index, which includes foreign large- and mid-cap stocks, would have exhibited only slightly higher volatility than the MSCI USA Index, as Exhibit 4 shows. This is a slightly higher allocation to foreign stocks than that of the average U.S. fund investor.

Exhibit 4 Portfolio Standard Deviation (%) by Allocation to Foreign Stocks (January 2000–June 2019)

	Allocation to Foreign Stocks (%)				Benchmark		
	20	33	40	50	MSCI USA	MSCI ACWI Ex US	MSCI ACWI Ex US Hedged
Unhedged	14.81	14.96	15.07	15.27	14.73	16.89	
Hedged	14.26	14.03	13.92	13.80			13.74

Source: Morningstar Direct. Note: The allocation to foreign stocks is represented by the MSCI ACWI ex USA Index. The balance of each portfolio is represented by the MSCI USA Index.

What's the right amount to allocate to foreign stocks? If the goal is to take full advantage of their diversification potential, and the correlations and volatility of U.S. and foreign stocks from January 2000 to June 2019 are representative of the future, the optimal allocation to foreign stocks is around 47%. [1] However, a 33% allocation over this period would have achieved 92% of the maximum diversification benefit.

More-risk-averse investors might consider a lower allocation, but if risk is the primary concern, it might also be worth considering currency-hedged exposure to foreign stocks. Currency hedging largely removes the volatility currency fluctuations create, bringing foreign stocks' volatility slightly below that of U.S. stocks. This allows larger allocations to foreign stocks to reduce portfolio volatility (up to a point), as the diversification benefits don't have to offset currency risk.

The downside is that currency hedging tends to be less tax-efficient than leaving the exposure unhedged, and currency-hedged funds tend to charge higher fees. Hedging can also be expensive when interest rates in foreign markets are higher than in the U.S. Currently, that's more of an issue in emerging markets than in most foreign developed markets. ...

The benefits of investing globally extend to factor strategies. The payoff to factors like value and momentum in the U.S. and foreign stock markets aren't perfectly correlated, as Exhibit 5 shows.

Exhibit 5 Correlation Between U.S. and Foreign Factor Returns Relative to the Market (June 2001–June 2019)

	Min Vol	Quality	Value	Small	Momentum
Correlation	0.81	0.44	0.52	0.33	0.69

Source: Morningstar Direct, Author's Calculations. Note: The factor returns were calculated using MSCI factor indexes for the USA and ACWI ex USA markets and subtracting the returns from the MSCI USA and MSCI ACWI ex USA indexes, respectively.

Those interested in taking advantage of these diversification benefits might consider Bronze-rated iShares Edge MSCI Multifactor International ETF (INTF) (0.30% fee) and Silver-rated iShares Edge MSCI Minimum Volatility EAFE ETF (EFAV) (0.20% fee). The former targets stocks with attractive value, momentum, quality, and small-size characteristics. The latter attempts to construct the least-volatile portfolio possible under a set of constraints. Both stick to large- and mid-cap stocks listed in foreign developed markets.

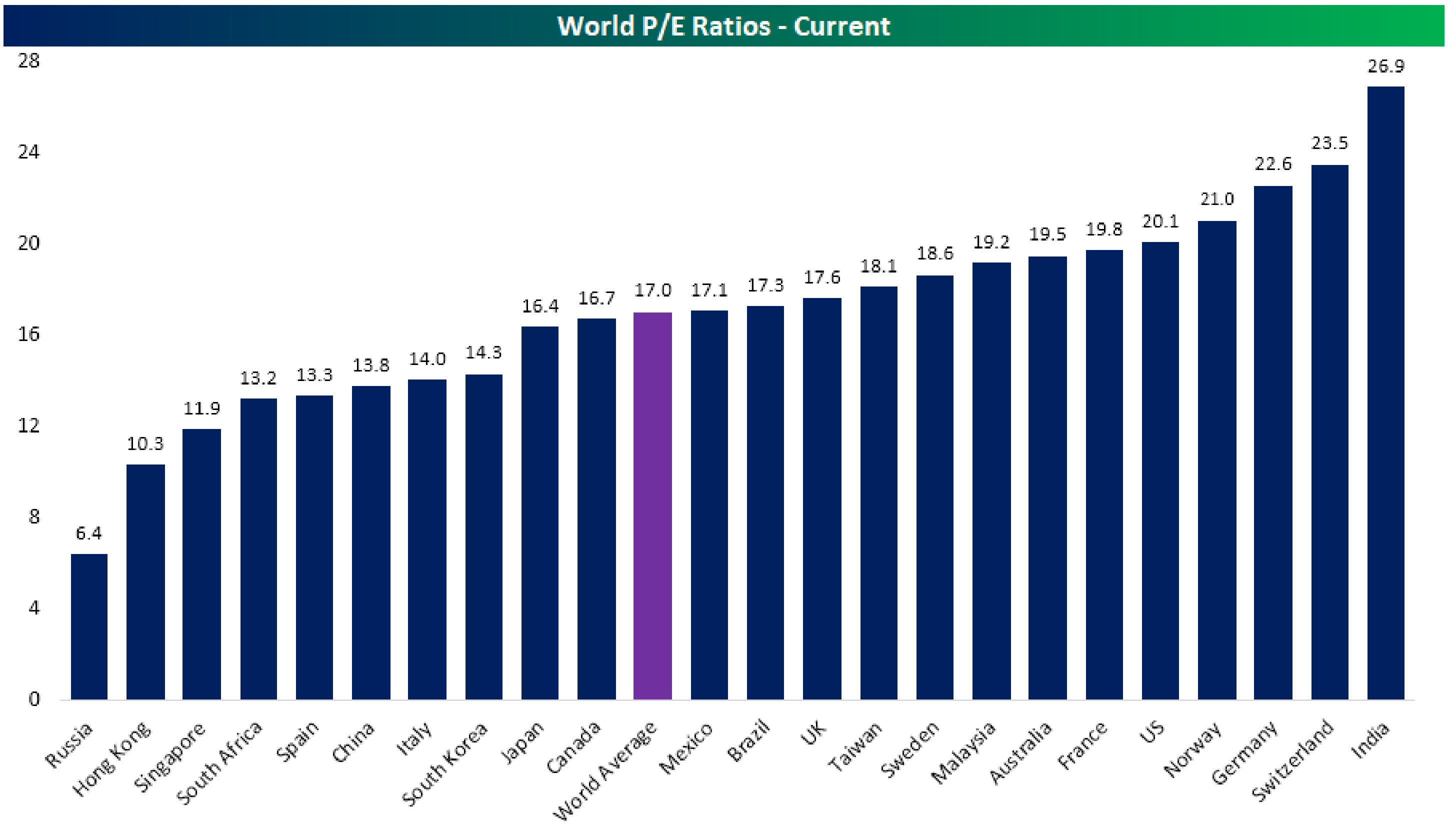
[1] This is the allocation that maximizes the diversification ratio developed by TOBAM, which is defined as the weighted average volatility of the portfolio's holdings to the portfolio's volatility.

From Bespoke:

Price-to-Earnings Around the Globe

Wed, Oct 30, 2019

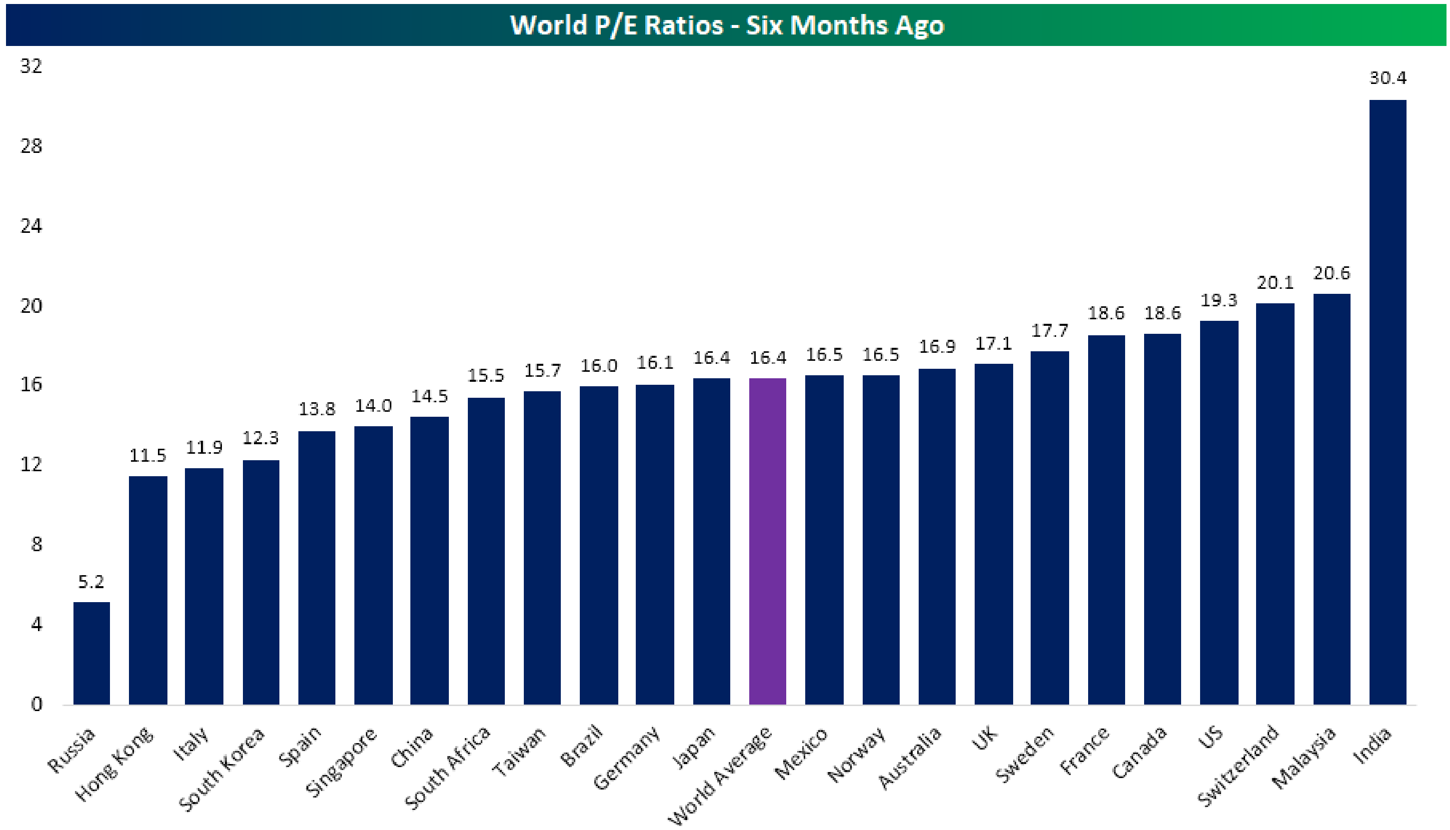
... India continues to have the highest valuation with a P/E of 26.9. That compares to the US which is now valued at 20.1x earnings and the fifth-highest of the countries tracked. This is also higher than the average P/E for all of these countries which is 17.02. Other countries with notably high valuations include Norway, Germany, and Switzerland. Russia (for reasons we have previously shared), on the other hand, has by far the lowest valuation of just 6.41, the only country with a P/E in the single digits.

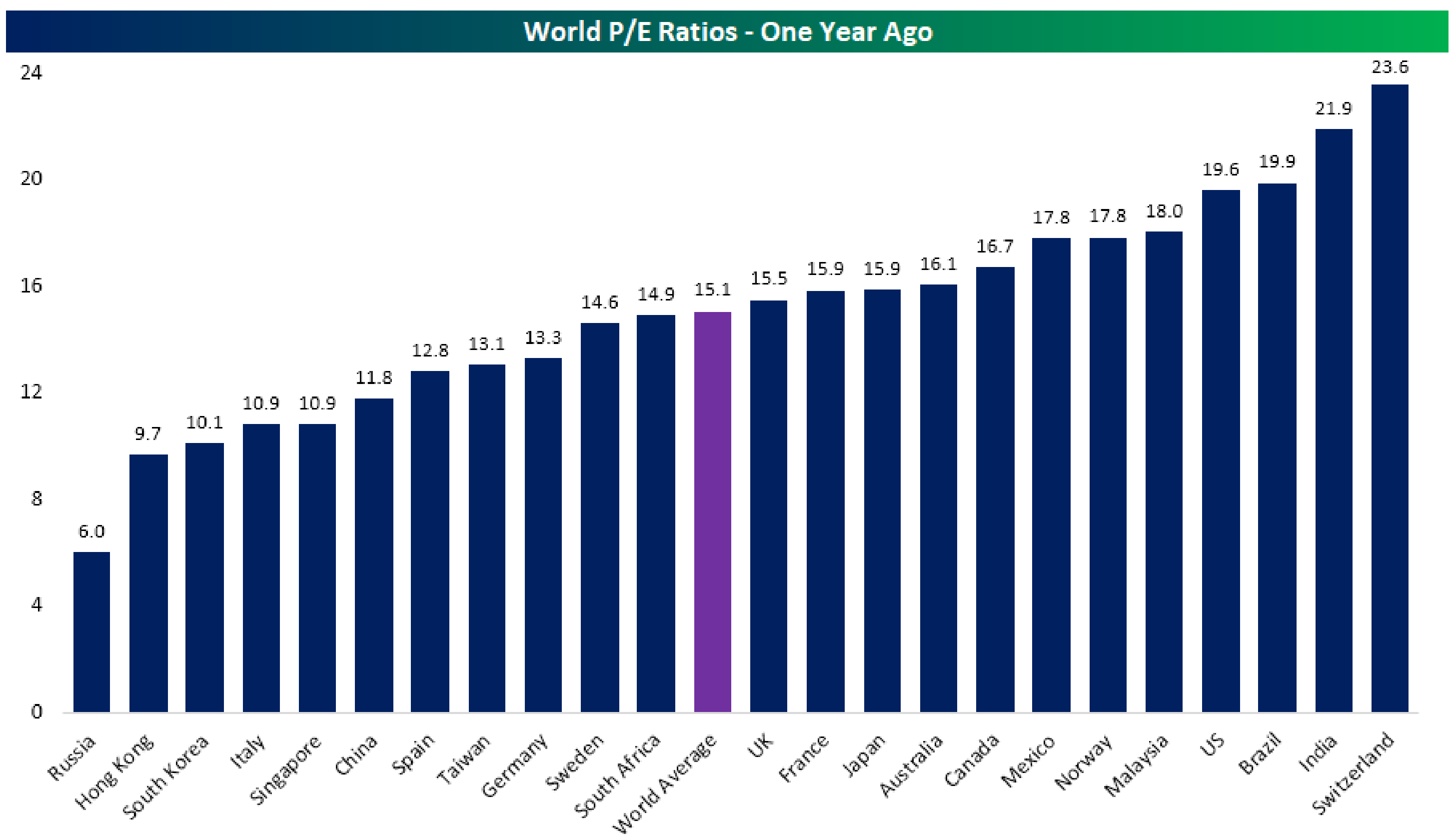


Compared to where things stood six months and one year ago, valuations around the globe have collectively risen. The world average now stands at 17.0 versus 16.4 at the end of April and 15.1 last October. While the average multiple has increased, only 60% of the countries tracked have seen valuations increase over the last 6 months while 74% have risen over the past year. Germany's P/E has actually risen the most of these having jumped to the third-highest P/E of all countries (22.6). Six months and one year ago, Germany (EWG) actually had a below-average P/E. Multiple expansion can come in the form of higher prices and/or lower earnings, and in the case of Germany, the culprit has been weaker earnings.

Even though it currently continues to hold the number one spot on the list, multiples in India (INDA) have actually fallen over the past six months from 30.4 down to the current level of 26.9. Given INDA has fallen over 2.5%, this lower valuation makes better sense than the jump in Germany. Similarly, in regards to the US, the ratio rising to over 20 from 19.28 comes is a result of the S&P 500's 3% gain as earnings have been pretty flat.

Compared to one year ago, it is a similar story. As is the case now, Russia and Hong Kong have had the lowest valuations over the past six months and one year, although they have risen in that time. The valuation for most countries have risen over the past year.





Summarizing in the table below, there is a bit of a mixed picture in regards to how P/E ratios have changed with performance over the past half-year and year. One would expect the ratio to increase as equities rise, but that has not necessarily been the universal case. For countries like Norway (ENOR) and Germany (EWG), valuations have risen the most in spite of equity markets that have experienced declines over the past six months (Norway's declines being the fourth-worst of the 23 countries) and only modest gains in the past year. On the other hand, Russia (RSX) has the lowest valuation of all countries despite having outperformed dramatically over the last six to twelve months. RSX has also not seen any major surge in valuation in that time as earnings have kept up with prices. Meanwhile, other countries like India (INDA), Switzerland (EWL), Taiwan (EWT) and the US (SPY) have seen this dynamic react more in line with what could be expected.

Country P/E Ratios Over the Past Year

Ticker	Country	Current P/E	P/E Change 6 Month	P/E Change Year	ETF Performance (%) 6 Months	ETF Performance (%) One Year
EWA	Australia	19.48	2.58	3.40	3.43	9.76
EWZ	Brazil	17.25	1.28	-2.64	6.91	10.19
EWC	Canada	16.71	-1.89	-0.02	0.52	8.45
MCHI	China	13.75	-0.72	1.96	-8.67	9.58
EWQ	France	19.75	1.17	3.90	0.55	9.64
EWG	Germany	22.57	6.49	9.25	-1.32	4.40
EWH	Hong Kong	10.32	-1.13	0.65	-11.01	10.80
INDA	India	26.88	-3.49	5.00	-2.82	14.74
EWI	Italy	14.02	2.13	3.17	0.26	13.41
EWJ	Japan	16.37	0.00	0.50	5.02	7.57
EWM	Malaysia	19.18	-1.44	1.15	-6.25	-7.80
EWW	Mexico	17.07	0.55	-0.76	-3.08	6.30
ENOR	Norway	21.01	4.48	3.17	-7.82	-11.73
RSX	Russia	6.41	1.26	0.37	12.65	16.49
EWS	Singapore	11.87	-2.08	1.02	-3.90	8.52
EZA	South Africa	13.22	-2.23	-1.71	-12.45	2.24
EWY	South Korea	14.28	1.97	4.15	-4.53	1.20
EWP	Spain	13.33	-0.43	0.53	-5.26	2.85
EWD	Sweden	18.63	0.92	4.00	-2.48	6.98
EWL	Switzerland	23.48	3.35	-0.14	5.56	15.89
EWT	Taiwan	18.12	2.39	5.04	8.16	17.61
EWU	UK	17.64	0.56	2.15	-3.76	2.14
SPY	US	20.06	0.78	0.45	2.90	11.95

Our thoughts

ISCF (blue line), which we use for clients, is the Multifactor International ETF from iShares that targets Small Caps. As shown below in Morningstar's chart, it has outperformed both INTF (orange line) and EFAV (green line), mentioned in the Morningstar article above, since inception:


ISCF +2,016.32 | +20.16%
INTF +673.19 | +6.73%
EFAV +942.24 | +9.42%
USD
15,000.00
13,500.00
12,000.00
10,500.00
9,000.00
7,500.00
2015
2016
2017
2018
2019
10,942.24