Keel Point

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Why We Own Non-US Stocks

The value proposition for non-US stocks is much maligned. This was a true statement even prior to the UK vote to leave the European Union on June 23; now it's even more emphatic. Clients have rightly asked if non-US stocks, which have plainly failed to keep pace with their US peers, are worth an allocation of their scarce portfolio capital.

Our thoughts will focus mostly on non-US developed economy stocks, where most of our non-US allocation resides. We use the MSCI EAFE, a market capitalization weighted index of larger companies primarily in the UK, Western Europe, and Japan, to proxy this segment of the equity universe. Comparisons to US will use the S&P 500. We begin with the charges.

Evidence Against

Through May, US stocks have outperformed non-US developed stocks over every major time period we considered (one, three, five, ten, twenty, thirty, and forty years, as well as since the shared beginning of our data set in 1970). Over the entire period, the US leads by about 1% per year. Worse, the gap has grown wider of late. And an adjustment for risk offers no redemption: US stocks have made money with less volatility (90% of the EAFE's) and with a shallower drop during the financial crisis.

It is tempting to discard an asset class that doesn't provide return improvement relative to your home country stock market over a long time period. We would agree that the stats above make a case for investing a *buy and hold* equity portfolio in only US stocks. However, we will show that there are many time periods in which non-US outperforms, and, for this reason, it is sensible to include an allocation in a *dynamically* managed equity portfolio in which allocations to US and non-US stocks periodically change via a rebalancing or over/underweighting process.

The Non-US Value Proposition

Our return comparison has an inherent bias – all time periods are calculated with May 2016 as the end date, thus locking recent non-US struggles in our analysis. Rather, we should consider, for instance, *all* three year periods ending each month from December 1972 to May 2016. Figure 1 makes this comparison. Blue indicates periods when non-US outperforms while red shows US outperformance. The last point in the graph, for example, shows that non-US stocks have lagged their US counterparts by 8.6% per annum over the period from June 2013 to May 2016.

The figure shows a cycling of return leadership between the two markets. Non-US did particularly well in the Japanese boom in the 1980s and throughout the better part of the previous decade. US stocks led the 1990s internet boom and again recently as the euro crisis weighed down many EAFE countries. The full sample of three year periods goes to non-US 44% of the time with an average outperformance of 9.9%. Conversely, the US wins out in 56% of the periods by an average of 8.3%.

Figure 1: When Non-US Outperforms
Rolling 3 Year Annualized Return of MSCI EAFE minus S&P 500
Sources: Bloomberg, MSCI

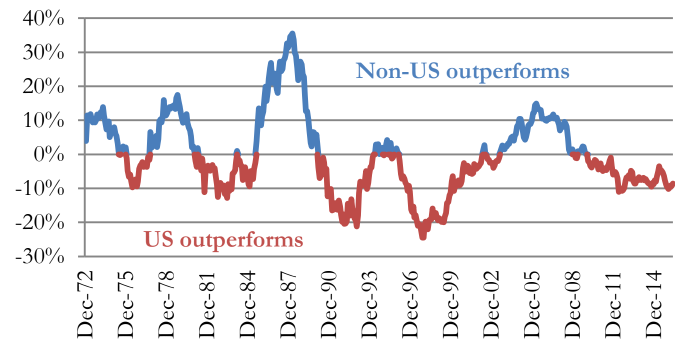


Figure 1 is also a reminder that while US and non-US stocks are highly correlated, they are not perfectly correlated. In other words, non-US stocks are not just watered down versions of their US counterparts (1% less flavor since 1970!). When the two separate, whether because of Japanese, internet, or the next mania, investors have an opportunity to dynamically reallocate. Rebalancing to pre-mania allocations or even underweighting a Japanese or internet bubble, forces a buy low, sell high portfolio discipline that can lead to better long-term performance. Said another way, dynamically moving capital to the out-of-favor category can boost results since the graph shows a tendency for that category to return to favor.

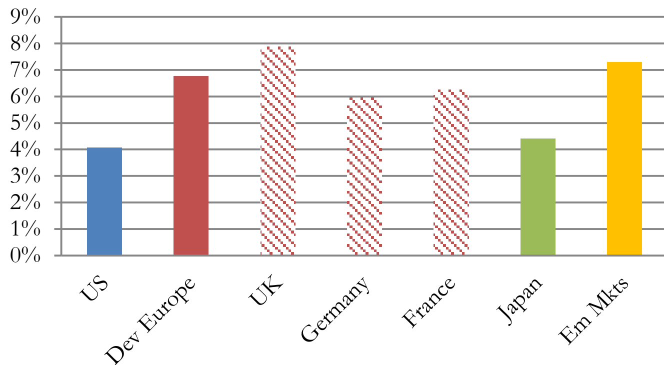
What Turns the Supertanker?

Of course, we need the red line to turn blue again at some point for this thesis to work. What is the catalyst for non-US stocks to make a fresh run at return leadership? We offer two: a potential valuation tailwind and the possibility for a currency headwind to subside.

First, consider Figure 2's assessment of the valuation differential between US and overseas markets. We've inverted Shiller CAPE ratios

– a cyclically adjusted (the "CA" in the acronym) version of a P/E ratio that uses a ten year period for calculating earnings (E) thus smoothing out variation caused by the business cycle – to calculate an earnings yield. Think of it as the amount, per dollar invested, you would take home each year on average if you owned the entire market. The US, with the lowest earnings yield, is the most expensive market on the page. Japan comes in slightly ahead, while developed Europe has a yield nearly 3 points higher. Emerging markets look just as attractive here as their developed market counterparts. Valuation differences aren't great predictors of short-term performance, but they do suggest, in this case, that non-US stocks have a long-term advantage due to their relative cheapness.

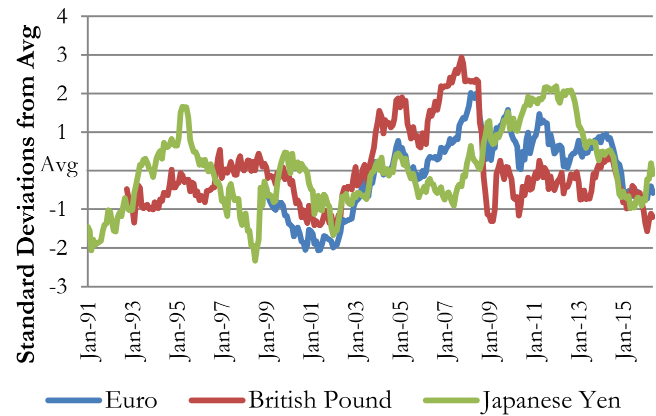
Figure x: Relative Valuations
Earnings Yields derived from Shiller CAPE Ratios
Data as of 3/31/16
Source: Star Capital



Second, the wind blowing head on from the foreign currency markets has started to subside. Dollar strength had weighed heavily over the last two years, a period of about 9% per annum dollar appreciation. A hypothetical non-US stock of constant value worth $100 two years ago would sell for $82 today due to the currency adjustment. But we view the chances of further dollar strength, and further negative currency adjustments, as diminished – most currencies now look undervalued.

Figure 3 offers one way to consider that presumption. Currency prices can be volatile, but they tend to oscillate around long-term averages. We calculate an average monthly closing price for the major developed country currencies going back as far as we felt represented the current monetary regime: to 1999 in the case of the euro (its inception), October 1992 for the pound (immediately after Britain dropped out of the European Exchange Rate Mechanism), and 1991 for the yen (immediately after their asset bubble burst). The graph shows how far, in terms of standard deviations, prices stray from that mean. For instance, the pound got to $2.08 in 2007, a full three deviations from its long-term mean of $1.63, before tumbling to $1.43 (1.3 deviations below the average) in the financial crisis.

Figure 3: Currencies Relative to History
Source: Bloomberg



The picture confirms recent dollar strength – all three currencies tumble over the last two years. But importantly it also shows that the trio is meaningfully under long run averages in the case of the pound and euro and right at the average in the case of the yen. Should the trio revert to their averages, a reasonable expectation over the long run, US investors would benefit. At the least the prospect for further currency adjustment losses is reduced.

Portfolio Expression

The equity portion of our portfolios has a significant weight to non-US stocks – just shy of 40%, most of which is in non-US developed. This represents just over a 10% underweight relative to the MSCI All Country World Index, our global stock benchmark. Despite negative headlines and lagging performance, we believe underweight (rather than zero weight) is the proper risk exposure. We believe there are negatives that need addressing: uncertainty leading up to and now confirmed by the Brexit vote and questions about debt, demographics, and ease of doing business in Europe and Japan for instance. But there are positives in the historical data and valuations that support the investment case. □

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