Heritage Wealth Advisors

Investment Insights: International Equity Investing

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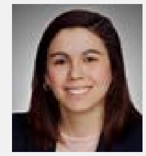

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At Heritage, we construct customized portfolios for clients designed to meet their specific wealth objectives. While each client portfolio is unique, our research suggests that a meaningful allocation to international equities should play an important role in achieving optimal results over the long-run. Below, we discuss the benefits of international equity investing and how we incorporate this asset class in client portfolios.

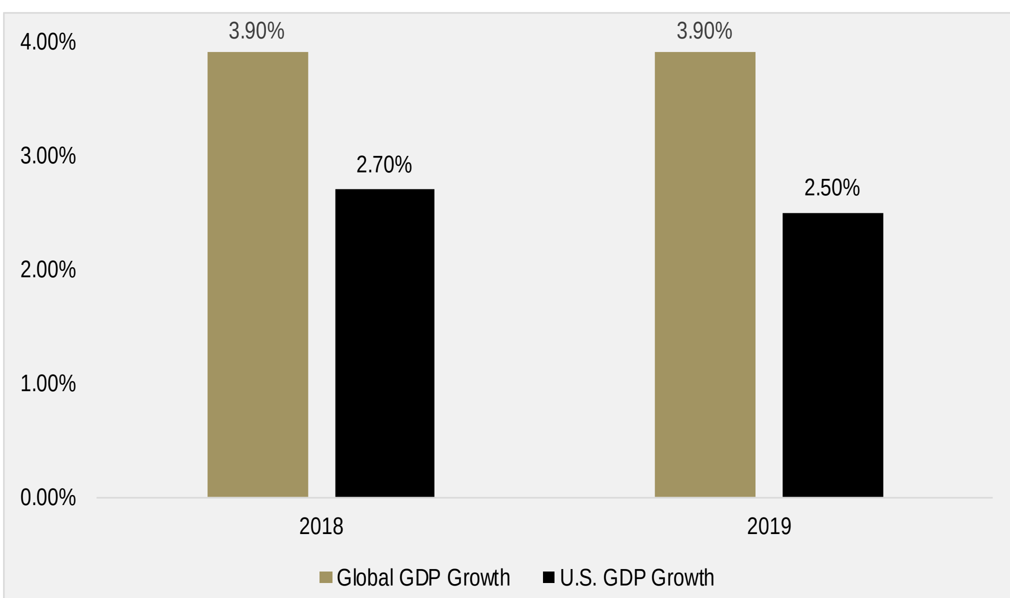
Gain an Advantage

International equities possess many attractive characteristics, including the following:

Growth Opportunities: International markets offer growth opportunities that may not be available in the U.S. While the U.S. is the world's largest economy, it makes up only 15.1% of global real GDP.[1] Over the last 15 years, global real GDP growth averaged 4.0% annually, above U.S. GDP growth which averaged 1.9%.[1] However, growth rates vary widely overseas. International markets are generally classified into two groups, developed and emerging markets, which are distinguished, in part, by the rate at which they are growing. International developed markets, such as the United Kingdom, Germany, Japan, Australia, and Canada, have established industries, widespread infrastructure, stable economies, and a relatively high standard of living. Emerging markets, on the other hand, such as Brazil, Russia, India, China, and Mexico, have less-stable economies, a lower standard of living, and developing capital markets. As a group, emerging markets are growing faster than developed markets as they work to improve their standard of living. Specifically, emerging market GDP growth averaged 6.0% annually over the past 15 years.[1] As countries mature, their growth rates slow, but this transition takes decades to play out, country by country. Emerging markets should continue to possess high growth potential for some time.

Synchronized global growth manifested last year, with 45 economies expanding – 33 at an accelerating pace.[2] The International Monetary Fund (IMF) forecasts global real GDP growth of 3.9% in both 2018 and 2019, above projected U.S. GDP growth of 2.7% and 2.5% (Exhibit 1).[1] Additionally, the IMF forecasts emerging market GDP growth of 4.9% in 2018 and 5.0% in 2019. Projected corporate earnings growth also looks attractive. Earnings per share (EPS) are expected to increase 8.9% in Europe in 2018, 1.3% in Japan, and 16.1% in emerging markets.[3] While recent tax legislation has provided a boost to 2018 estimated EPS growth in the U.S., currently 18.6%, long-term earnings growth prospects are more appealing overseas.[4] European and emerging market earnings are trending upward, but profit margins remain below the long-term historical average, implying further upside potential. U.S. earnings, in contrast, have been strong on the back of solid margin expansion, suggesting limited upside. Strong earnings growth should support higher valuation multiples and positive returns.

Exhibit 1: International Monetary Fund: Real GDP Growth Forecast



Expanded Opportunity Set: International markets offer an expanded universe of investment options. U.S. stocks represent less than half the global equity universe based on market capitalization. About 4,300 companies are publicly-listed in the U.S., compared to over 43,000 worldwide.[1] Many industry-leading businesses are headquartered outside the U.S. and generate most of their revenues in international markets. They include household names (e.g. Swiss-based Nestle and Belgium-based Anheuser-Busch Inbev) as well as lesser known companies. For example, while the FAANG stocks (Facebook, Amazon.com, Apple, Netflix, and Google) led U.S. equities last year, returning 49.1%, a group of Chinese technology stocks (Alibaba, Baidu, JD.com, and Tencent) performed even better, up 79.1% (Exhibit 2).[4] Some of the most innovative businesses in the world reside in international markets. For instance, these four Chinese companies are driving progress in artificial intelligence and other revolutionary areas. They are large businesses, totaling $1.1 trillion in market capitalization.[4] Opportunity also exists in smaller companies. There are nearly three times as many international small cap equities as large and mid-cap.[5]

Exhibit 2: The FAANGs Underperformed a Group of Chinese Technology Stocks Last Year

FAANGs		Chinese Technology Stocks	
Name	2017 Return	Name	2017 Return
Facebook (Social Media)	53.4%	Alibaba (E-Commerce)	96.4%
Amazon.com (E-Commerce)	56.0%	Baidu (Search Engine)	42.5%
Apple (Electronic Devices)	48.5%	JD.com (E-Commerce)	62.8%
Netflix (Media)	55.1%	Tencent (Social Media)	114.7%
Alphabet Inc (Google) (Search Engine)	32.9%		
Average	49.2%	Average	79.1%

Attractive Valuations and Dividend Yields: International equities currently are trading at lower valuation multiples than U.S. stocks, suggesting higher return potential. Specifically, the MSCI EAFE Index, which measures a basket of stocks in developed international markets, trades at 14.1x estimated next 12-month earnings, while the MSCI Emerging Markets Index, which measures a basket of emerging market equities, trades at 12.6x, below the S&P 500 Index which trades at 17.1x (Exhibit 3).[6] Importantly, international equities are priced more attractively compared to their long-run historical average. The MSCI EAFE Index trades below its long-run average of 16.4x, while the MSCI Emerging Markets Index trades in line with its long-run average of 12.6x, versus the S&P 500 Index which is slightly above its long-run average of 15.8x.[7] Higher forward price-to-earnings multiples have historically resulted in subsequently lower returns. Additionally, international equities provide higher yields. The MSCI EAFE Index yields 3.1%, while the MSCI Emerging Markets Index pays 2.3%, above the S&P 500 Index which pays 1.9% (Exhibit 4).[6]

Exhibit 3: Price to Estimated Next 12-Month Earnings

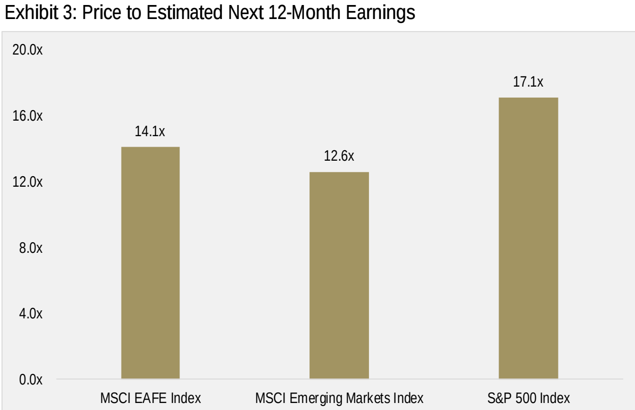
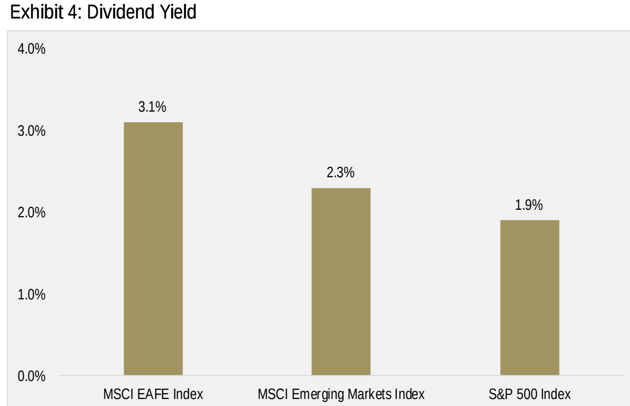


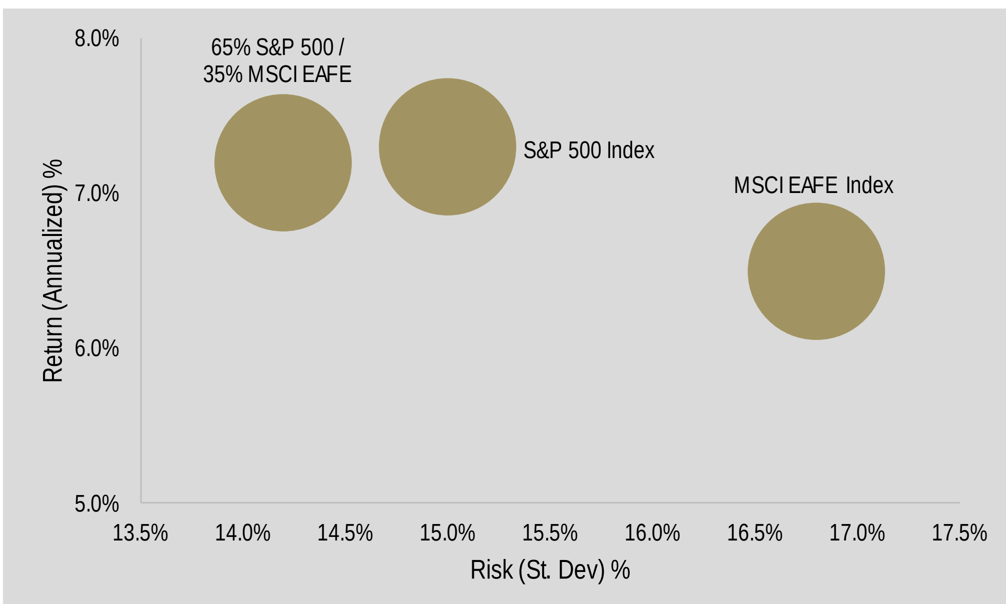
Exhibit 4: Dividend Yield



Return Reversion Potential: While international equities outperformed U.S. stocks last year, they are lagging on a multi-year basis; positive trends in corporate earnings combined with lower valuations suggest that they have potential to benefit from return reversion. International equities, as measured by the MSCI All Country World Index ex USA Index, notched an impressive gain of 27.2% in 2017, outperforming the S&P 500 which returned 21.8%.[4] Despite such strong performance, international equities are still experiencing their longest streak of cumulative *underperformance* on record (116 months).[5] After the previous period of underperformance (90 months ended 12/31/2001), they outperformed for 78 months.[5]

Diversification Potential: International equities can enhance the overall risk-return characteristics of a portfolio. From 1970 to 2017, the MSCI EAFE Index returned 6.5% annually with volatility (standard deviation) of 16.8%, compared to the S&P 500 Index which returned 7.3% with volatility of 15.0%.[4] Owned together, however, the resulting portfolio generated superior risk-adjusted returns. For example, a 65% S&P 500 / 35% MSCI EAFE portfolio returned 7.2% with volatility of 14.2% (Exhibit 5).[4] The portfolio returned 0.51% per unit of risk, higher than the MSCI EAFE Index which returned 0.39% and S&P 500 Index which returned 0.48%. International equities can offer diversification as they are a heterogeneous group with different economic drivers, political environments, and currencies. As mentioned, international equities are experiencing their longest streak of cumulative underperformance on record. Excluding this unusual period, the data suggest that international equities can play an even greater role in enhancing risk-adjusted returns. From 1970 to 2012, the S&P 500 Index returned 6.6% with volatility of 15.6%.[4] A 65% S&P 500 / 35% MSCI EAFE portfolio returned 6.9% with volatility of 14.7%, higher return and lower volatility than the U.S.-only index.[4]

Exhibit 5: Risk-Return Characteristics



Accessing the Asset Class

Presently, we incorporate international equities in client portfolios primarily using active management – investment strategies designed by professional managers with the objective of beating the index that serves as the relevant comparison benchmark. Effective active strategies generate higher returns than the index or provide risk mitigation within a portfolio. Given the breadth of the asset class, the dispersion of returns is large, creating opportunities for active management. The composition of the index may be suboptimal as well. For example, Chinese and Taiwanese stocks make up 40.7% of the MSCI Emerging Markets Index.[8] Active management can offer better diversification.

We select experienced managers with a clear, consistent investment philosophy and process that align with ours views on managing money. Funds with low fees and expenses, low turnover, and tilted away from any undesirable exposures in the index can deliver optimal results. As it relates to international equities specifically, we choose managers with a proven ability to navigate the unique challenges associated with the asset class (Exhibit 6). For example, foreign governments can be less stable and have restrictions on how freely businesses operate. Additionally, obtaining timely and accurate financial information may be difficult, and there can be differences in accounting standards.

Exhibit 6: Characteristics of Top Active Managers
• Clear, Consistent Investment Philosophy and Process
• Low Fees and Expenses
• Low Turnover
• Tilted Away from Any Undesirable Exposures in the Index
• Proven Ability to Navigate Unique Challenges Associated with the Asset Class
• Discipline

Our decision to invest in international equities is not a one-time determination but rather a continual assessment. The quality and depth of our investment management platform allow us to continually evaluate our asset allocation, investment vehicle, and manager selection decisions to implement shifts in client portfolios as necessary.

Conclusion

Our research suggests that a meaningful allocation to international equities should play an important role in achieving optimal results over the long-run. Presently, we incorporate international equities in client portfolios primarily using active management. However, we continue to evaluate our asset allocation, investment vehicle, and manager selection decisions to drive the best solutions for clients. If you have questions about international equity investing, or any aspect of your investment portfolio, please contact a member of Heritage's Investment Research Team or your Advisor.

[1] International Monetary Fund
[2].Organisation for Economic Co-operation and Development
[3] Goldman Sachs: 3/19/2018 Global Weekly Kickstart
[4] Morningstar
[5] Brandes Investment Partners
[6] JPMorgan 3/19/2018 Weekly Market Recap
[7] BCA Research
[8] MSCI