EQUIUS ASSETCLASS℠

Modern asset class investing principles, research, and perspectives for long-term investors

June 2019

An International Pain In The…

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It's always something!
—Roseanne Rosannadanna

For over 38 years, from January 1970 to June 2008, the S&P 500 and MSCI World ex USA indexes produced annual returns of 10.6% and 10.4%, respectively. This empirical record—along with global cost of capital, similar political systems and respect for the rule of law, free-market economies, and other considerations—has led academics in financial economics to conclude that the stock markets of the U.S. and of foreign developed markets have the same *expected* return over time.

Yet, from July 2008 to May 2019 (almost 11 years) the S&P 500 has produced an annual return of 9.6% while the MSCI index has generated a meager 2.0% annual return.

How should we, as long-term investors, react to this?

Well, we could begin to think and act like active managers, diving into the complexities of each foreign developed economy for signs of long-term systemic changes that predict a different expected return. We could then adjust our long-term U.S. and foreign allocations to reflect those predictions.

Of course, too many investors and fund managers did this in the 1980s when it appeared that Japan had all the economic answers. The glory days in the U.S. were past, they predicted, so let's increase our foreign exposure, especially to Japanese stocks. They were wrong.

They did this again in the late 1990s when a "new era" was born and U.S. large growth stocks—mostly related to technology— dominated. Billions of dollars shifted to dot-com, biopharmaceuticals, and telecommunications stocks until that trend ended abruptly in 2000. Once again, investors and fund managers were wrong.

Many of these same investors decided then to invest much more heavily in real estate and other "alternative strategies"—and were slapped back into reality with the global financial crisis. Unfortunately, millions of them missed, to varying degrees, the dramatic recovery in both stocks and real estate since 2009. Meanwhile, Equius clients, instead of experiencing a "lost decade" from 2000-2009 or diluting our equity returns *after* 2009, have benefitted greatly because of our persistent exposure to foreign, small-cap, and value stocks.

It's a fact of investing life that the performance of individual asset classes cycle on a relative basis from good to bad. That's why we diversify. If we could predict cycles in advance, we wouldn't diversify, right? Today the cycle favors U.S. stocks and disfavors foreign stocks in general. At other times this trend was reversed. If your memory has faded on this point, take a look at the charts on the next page. Then ask yourself: *Am I willing to bet that things have so fundamentally changed in the foreign markets that I should reduce my international allocation or wipe it out completely?*

If so, then consider *how long* you'll be willing to stay with that decision.

Why is global diversification important?

When two asset classes such as U.S. and foreign stocks have the same expected return, why invest in both?

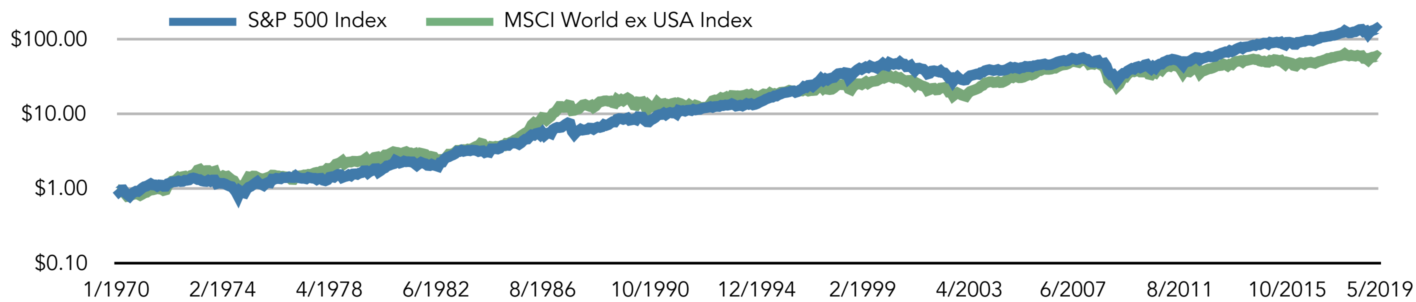
One answer is evident in the charts that follow: when you're feeling bad about U.S. stock performance, you'll probably find that foreign stocks are doing better—and vice versa. In other words, you're more likely to "stay in the game" when the performance of one asset class is offsetting disappointing returns in another.

Another answer comes from modern portfolio theory and basic mathematics: when you combine two volatile but uncorrelated asset classes with similar returns, over time this portfolio will benefit from a "diversification premium."

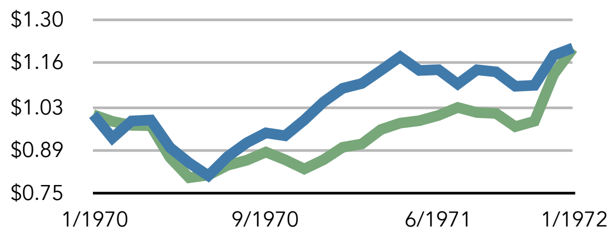
A good example is the period 1970 to June 2008 that I presented at the start of this article. The S&P 500 and MSCI indexes returned 10.6% and 10.4% annually, respectively. Yet, a *portfolio* of 70% S&P 500 and 30% MSCI World ex USA, rebalanced annually, produced an annual return of 10.8%, or 0.30% higher than the average of the two asset classes alone. An extra 0.30% compounded over time is not an insignificant amount. And, with smart diversification, it's free.

Some investors will choose to alter their global allocations based on returns of the recent past or predictions of systemic changes in foreign economies or the U.S. market. At Equius, as always, we choose to maintain a steady course, rebalance when necessary, and reap the benefits of patience and efficiently-diversified asset class portfolios.

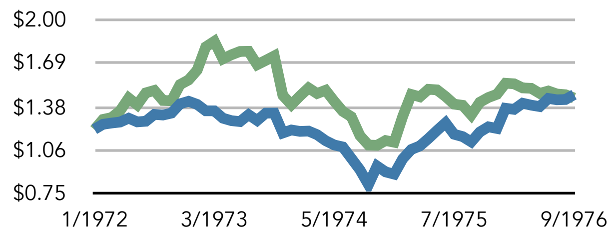
1: The full period: 1970 to Apr. 2019 (logarithmic, all others linear)



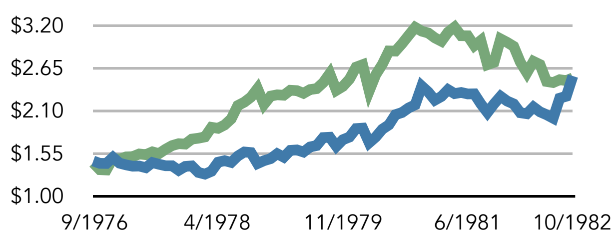
2. U.S. takes off, international catches up



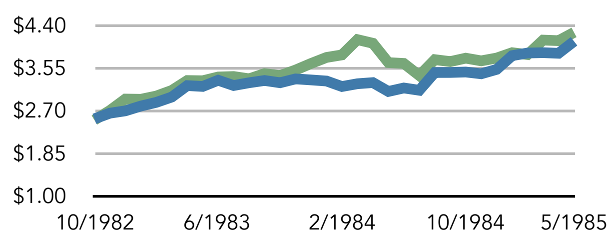
3. International takes off, U.S.catches up



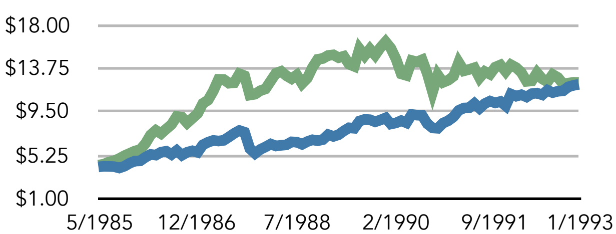
4. International takes off, U.S. catches up



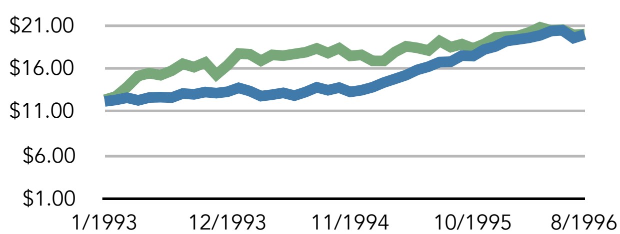
5. International takes off, U.S. catches up



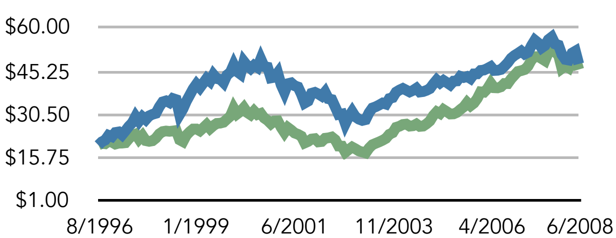
6. International takes off, U.S. catches up



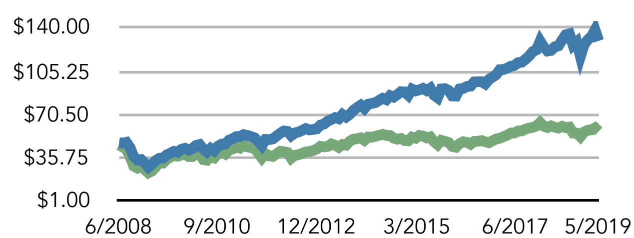
7. International takes off, U.S. catches up



8. U.S. takes off, international catches up



9. U.S. takes off, international catches up?



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