The Case for Global Equity Investing

EDGE is an independent financial firm whose objective advice helps individuals and institutions realize their goals in the areas of investment management and corporate finance. The Edge Research Team's thoughtful and timely reports are based on extensive independent research and analysis of firms, financial developments, and macroeconomic trends.

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Why should I invest in any equity outside the United States? It is a relatively simple question, and one that we hear more and more often. The question has become more emphatic with the passing time and continuing trend of US outperformance (economically and in financial markets).

We will try to keep our answer simple as well. Because it makes sense. A long-term, disciplined investor has to look past where we are in the current portion of the cycle to what is likely next to come. Chasing the performance of what has worked most recently will eventually catch up with you as inevitably the rush pushes valuations up to a point where future returns fall. While the United States is the largest single economy in the world, it still represents a little less than a quarter of global economic activity. While the US equity market is the largest by capitalization (in the MSCI All Country World Index), it is only a little more than half of total market value. In terms of the number of publicly listed companies, the US has less than 20% of the companies listed in the developed world (OECD countries) and even lower if we include emerging markets. It is a big world out there.

Granted, the US is more mature in its economic recovery and US-based investors are likely more comfortable grappling with the problems we see at home than the ones we see abroad. Doing so ignores facts that, in the big picture, support why we want a balance of geographic equity exposure for the long-term. Below are the top five big-picture reasons we think global diversification makes sense. There is no way of knowing when we will reap the benefits, but these reasons support why we will in time.

1. US equity outperformance is nearing historic duration.

Historically, there has been a rotation between which equity market is outperforming. While each cycle is driven by a different set of circumstances, tides eventually turn and leadership changes. Below is a table reviewing the historic cycles to put the current turn in context. As you can see, the duration of the recent outperformance of the US is nearing the longest in over forty years.

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A Historical Perspective On International Diversification

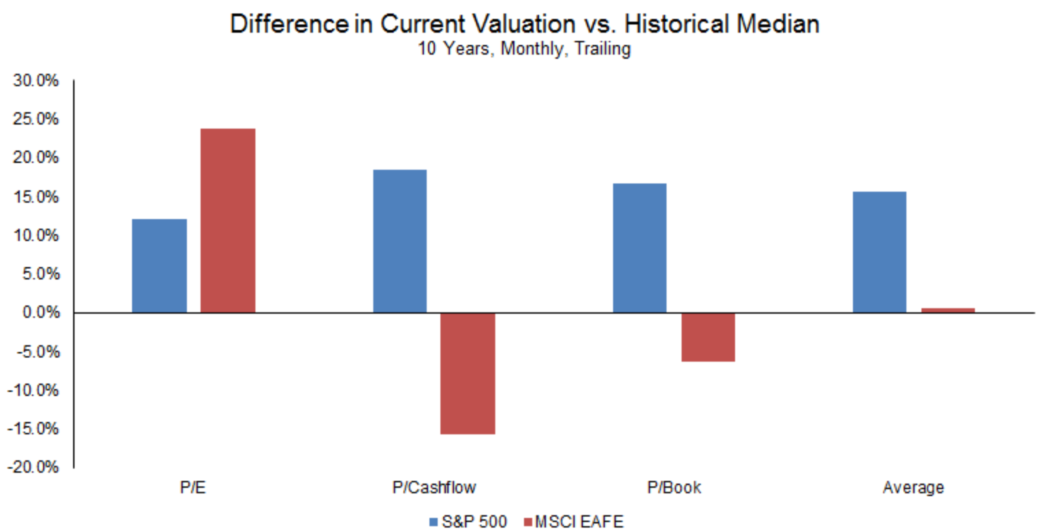
	Asset Class Outperforming	Start Month	End Month	Duration in Months	MSCI EAFE Cumulative Return	S&P 500 Cumulative Return	Difference Between Outperforming & Underperforming Asset Class
	International Equities	Mar-71	Jun-73	28	68%	11%	57%
	US Equities	Jun-73	Sep-76	40	-28%	15%	44%
	International Equities	Sep-76	Dec-78	27	54%	2%	52%
	US Equities	Dec-78	Jun-83	55	23%	122%	99%
	International Equities	Jun-83	Dec-88	67	351%	104%	246%
	US Equities	Dec-88	Dec-92	49	-22%	79%	101%
	International Equities	Dec-92	Jun-94	18	41%	6%	35%
	US Equities	Jun-94	Mar-02	94	10%	195%	186%
	International Equities	Mar-02	Jun-08	76	107%	25%	81%
Current	US Equities	Jun-08	Feb-16	92	3%	78%	75%

Avg when MSCI EAFE Outperforms	43	124%	30%
Avg when S&P 500 Outperforms	66	-3%	98%

Source: Edge Capital & Bloomberg

2. Valuations are lower outside of the US.

The US equity market valuation multiples have moved higher to reflect a quicker corporate profit recovery than the rest of the developed world. In looking at the numbers, valuations outside the US look more favorable. Lower valuations imply higher future returns. It is important to note that across geographies, the impact of earnings troughs in the energy and financial sectors globally are pushing up trailing reported price/earnings ratios. At this point in the cycle, looking at price/operating cash flow and price/book as a reflection of normalized earnings potential and to compensate for regional accounting difference makes sense.



Source: Edge Capital and Bloomberg

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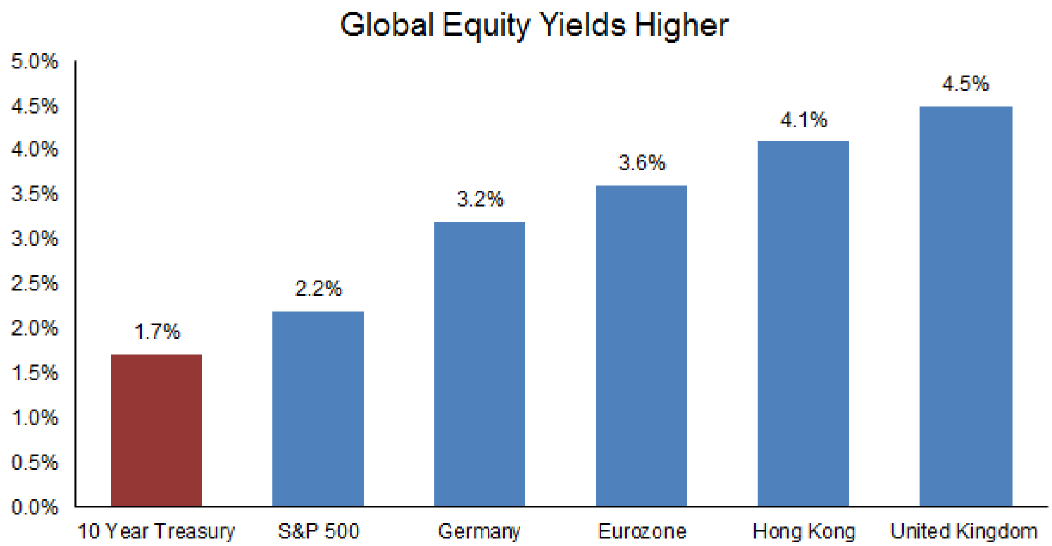
3. Dividend yields are higher outside of the US.

While dividends are part of expected total returns, we continue to favor getting a higher portion of our expected return from current pay. This is especially true in an environment where fixed income yields remain persistently low and equities are used as a replacement to meet income targets. In addition, companies that have a stable history of paying and growing dividends tend to weather market volatility better than those that do not. As you can see, dividend yields outside the US offer significant opportunity to generate incremental cash flow in portfolios.



Source: Bloomberg as of 4/11/2016

4. The US Dollar rally already factors in US economic recovery.

In the medium-term, currencies tend to reflect the relative economic strength of one region versus another. One of the reasons for this is the difference in interest rates that is created as the demand and supply of money shifts to reflect increasing economic activity. As the US has recovered and monetary policy changes gears, it has been widely anticipated that interest rates will rise. Appropriately, the US Dollar has rallied. The question, therefore, is how much is priced in at this point. While the US Dollar is not back to highs seen back in 2002 (as the euro entered physical circulation for the first time), it is well above the levels seen in the 2008/2009 Financial Crisis and the 2010 European Sovereign Debt Crisis.

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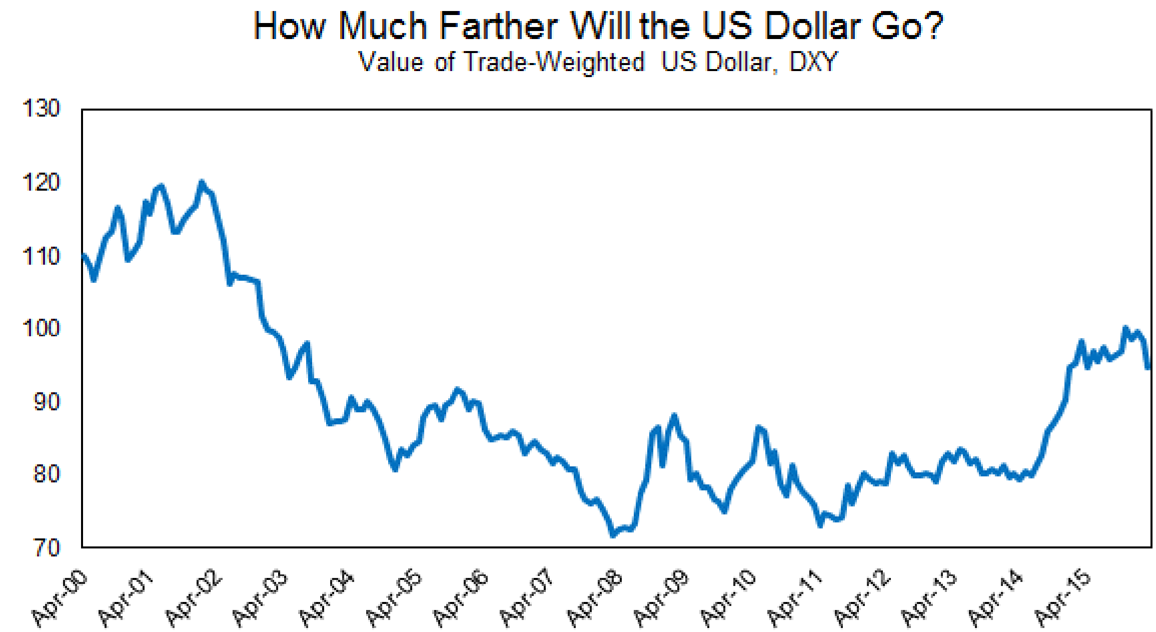

Source: Bloomberg

5. The relationship of returns between geographies is falling.

From a risk management perspective within a portfolio, we seek to own assets that we have conviction will make money but will do so in a different way than the others. In other words, we want to own some investments that "zig" while others "zag". Diversification is created across asset classes and sectors, but also across geographies. The scorecard we use for diversification benefit is called correlation. Correlation measures the strength of the relationship between returns between +1 (zig and zag together always) and -1 (zig while the other zags always) with 0 being no relationship at all (the best for diversification). While we should expect the correlation between large cap companies in the US versus other developed markets to be on the higher side generally, the relationship spiked after the 2008/2009 Financial Crisis and has been falling back more recently. A falling correlation means that the long-term risk-reducing benefit of an allocation to non-US equities is increasing.

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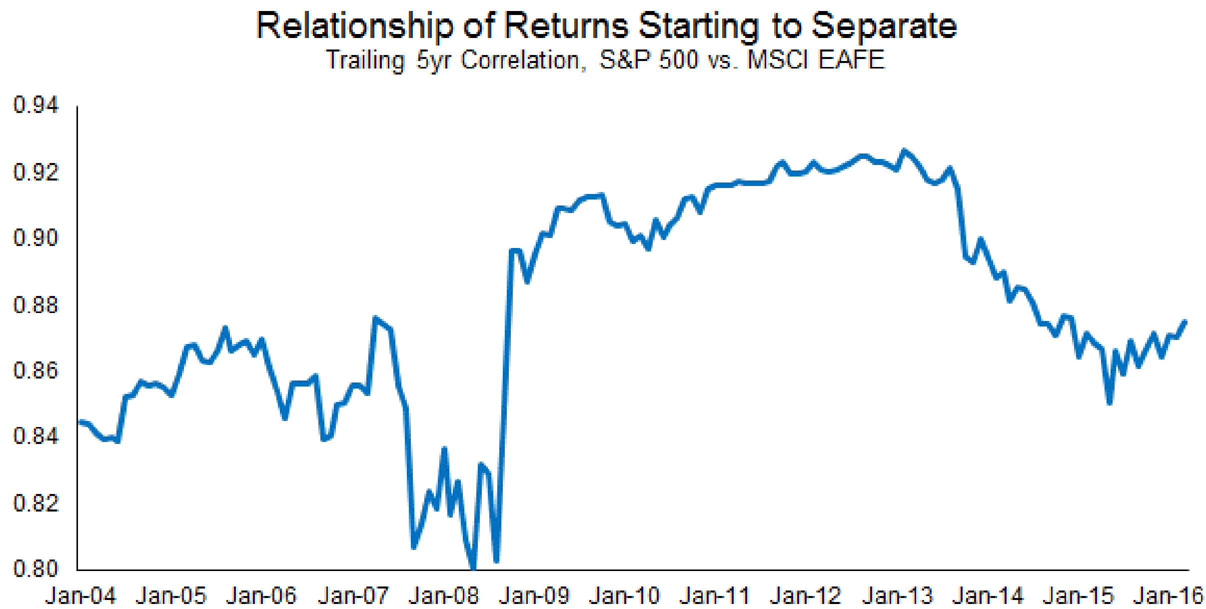

Source: Edge Capital and Bloomberg

Summary

In summary, we lay out five simple reasons why we think a long-term equity investor should be diversified across geographies. As in most aspects of investing, there are cycles to relative market performance. The current leadership of the US equity market over its global peers is reaching historic lengths. Valuation for equities outside the US is lower which implies higher future return. Dividend yields are also higher meaning that we get more of that total return in the form of current cash flow. The strength of the US Dollar has strengthened reflecting the country's relative strength and the diversification benefit of an international allocation is increasing. While markets do not behave based upon calendars, the case for global diversification will win over time.