Why Your Portfolio Needs Global Exposure

361 CAPITAL

Since inception of the MSCI EAFE Index at the end of 1969, U.S. stocks have outperformed in 23 of 47 calendar years on a price-return basis, or just under 50% of the time. Annualizing those returns, the U.S. has done a bit better, advancing by 7% per year vs. 6.2% for EAFE, again, on a price-return basis (selected because total return data for the EAFE only goes back to the mid 1980s). Further, since 1987 when total return data did become available for the EAFE, U.S. stocks have earned considerably more of their total return through price appreciation, and less from dividends, than have their foreign counterparts. Point being, the longer-term data based solely on price likely gives the U.S. an advantage, and even with that advantage, it's basically been a coin flip as to whether the U.S. would outperform international stocks in any given year. So where are we going with this?

Cliff Stanton, CFA
Chief Investment Officer

The opportunity set for equity investors continuously evolves, and we think many investors routinely miss out on the chance to earn higher returns because of the way they structure portfolios (which in turn is a function of how asset managers build and market products, but we'll leave that alone for the time being).

Globally flexible managers have been shifting allocations of late, as it's become more and more evident that U.S. stocks are overvalued and due for a correction, and as improving economic data and sentiment abroad boosts foreign markets.

> "According to Bank of America Merrill Lynch's monthly fund managers' survey, the allocation to U.S. stocks by global fund managers fell to net 28 percent underweight, the largest underweight since November 2007. At the same time, those overweight in emerging markets stocks is the highest since December 2010."
> – CNBC (September 12, 2017)

The key here is that these are "global" fund managers. They aren't constrained to specific countries or regions, and so, as the opportunity set changes, they go to where stocks are most attractive.

In the bestseller *The World is Flat: A Brief History of the 21st Century*, Thomas Friedman argues that the world is now a more level playing field than it has ever been in history, and that as a result, geographic divisions are increasingly irrelevant. We concur with that assessment and believe that it has ramifications for how portfolios are (or should be) constructed. And we aren't alone; there is evidence that institutional investors have been of this mindset for a while now, as pointed out in a 2010 study by MSCI Barra that concluded, "In summary, our findings suggest that

KEY TAKEAWAYS

- It's become more evident that U.S. stocks are overvalued and due for a correction, while improving economic data and sentiment abroad has boosted foreign markets.
- While institutions have been migrating away from regional mandates in favor of global mandates, individual investors have been slow to follow their lead.
- It may be advantageous to employ global managers in order to simplify the asset allocation and portfolio construction processes.

global equity mandates…may be emerging as the 'new classic' structure for implementing equity allocations." But while institutions have been migrating away from regional mandates in favor of global mandates, individual investors have been slow to follow their lead. We believe that advisors need to help individual investors increase the speed of adoption of globally oriented strategies.

To begin, consider the following data from Morningstar as of September 13, 2017.

Global fund managers aren't constrained to specific countries or regions, and so, as the opportunity set changes, they go to where stocks are most attractive.

Broad Category	# of Funds	AUM (in billions)	% of Total AUM
U.S. Equity Funds	2276	6,172	75.0%
International Equity Funds	529	1,616	19.6%
Global Equity Funds	310	441	5.4%
	3,115	**8,229**	**100%**

Two things are immediately clear from these numbers. First, global equity funds are far from mainstream, with only a 5% market share across these categories. Second, assuming that the assets in U.S. and international funds are a good proxy for the breakdown of the typical investor's equity allocation, there is a rather large home country bias. The weighting to the U.S. within the MSCI World Index is approximately 59%, so a market-weighted portfolio would have a similar exposure to U.S. equities. But that is not what we see in the data; U.S. equities make up a disproportionate 80% of the assets in the two categories.

So why do we believe that investors should consider allocating to global strategies? For one, global markets have become considerably more integrated over the last few decades. As a result, industry factors now dominate country factors in terms of explaining stock market returns. Additionally, most mid- to large-cap companies now generate substantial revenue abroad. In fact, overseas revenues to S&P 500 companies exceeded 43% in 2016. Where a company domiciles is much less relevant than it used to be.

Another benefit of a global focus is the improved opportunity set. An analyst covering semiconductors, for example, needs to understand and have a view, not only of U.S. based firms like Intel, Micron Technology and AMD, but also Samsung and SK Hynix in South Korea, STMicroelectronics in France, and Infineaon Technologies in Germany, to name a few. If that analyst is going to do the work to form views on those geographically diverse firms, why artificially constrain the buy decision to U.S. firms? European firms? Asian firms? Doing so introduces information leakage into the investment process.

It may also be advantageous to employ global managers in order to simplify the asset allocation and portfolio construction processes. The more granular the mandate (think "U.S. mid-cap value" as opposed to "U.S. equity") the more granular the capital market assumptions need to be, which adds complexity and increases the sources of error. Further, as investors have come to understand and include an increasing number of asset classes and strategies when constructing portfolios, the number of managers utilized has ballooned. When investors mainly allocated to U.S. equities, international equities and investment grade bonds, portfolios were quite simple. But now, it's common for even retail investors to have exposure to TIPS, emerging market equities, real estate, and a host of alternatives, for example. While we believe in broadly diversifying across asset classes, geographies and strategy types, doing so results in significant complexity, complexity that can make it difficult to understand the true risk exposures within a

portfolio. That complexity can be lessened in part by employing a smaller number of globally focused managers.

Finally, due diligence, properly done, is a resource intensive process, so if you are going to do the work to identify skilled managers, why artificially constrain them once identified? By making larger allocations to fewer high conviction, geographically unconstrained managers, both the initial search costs and the ongoing monitoring costs are lessened. Additionally, allocating more money to fewer managers allows for the possibility of reduced investment costs, because of the ability to access institutional share classes of mutual funds, and because of the declining fee schedules for separately managed accounts.

Going global has many advantages, and given the duration of the current bull market in U.S. stocks, these advantages may be of increasing importance in the foreseeable future.

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About 361 Capital

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