

Global Value and Income Dispatch

Equity Market Xenophobia: Is It Justified?



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Highlights

Investors are losing patience with underperforming international equities

U.S. tech stocks and dollar strength largely account for the divergence

Theory, logic and experience all favor maintaining a broad-based and global opportunity set

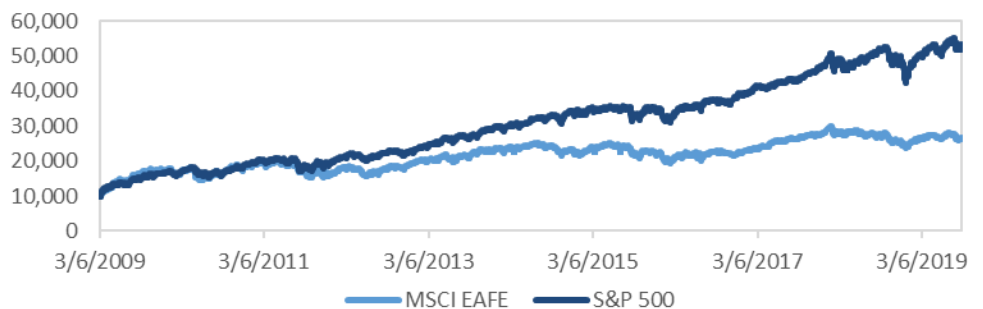
Over the past decade, global investors have struggled with the undeniable reality that international equities have delivered substantially inferior returns compared with U.S. stocks. Many have even called into question whether they should allocate to non-U.S. equities at all.

How bad is it? From year end 2007 through year end 2018, the MSCI EAFE Index (perhaps the most widely referenced index of non-U.S. developed market stocks) outperformed the S&P 500 Index in only three out of eleven years (2009, 2012, 2017). During that time frame, the S&P 500 outperformed the EAFE by approximately 6.3% per year on a compounded basis (7.2% versus 1.0%). In the three years when the EAFE outperformed, the average magnitude of outperformance was 4.0%. In the other eight years, the S&P 500 outperformed each year by an average of 9.3%. The year 2019 is not shaping up to be any better on a relative basis for foreign stocks, with the S&P 500 delivering a year to date total return through August 30, 2019 of 18.3% versus 10.2% for the EAFE.

Investors who were sufficiently clairvoyant to put money to work on the worst day of the Great Financial Crisis (March 6, 2009) have been amply rewarded as global capital markets have recovered and grown. But those who bought U.S. stocks received the lion's share of the rewards. If you invested \$10,000 on that date into the S&P 500 Index, it would be worth more than \$53,000 as of August 30, 2019. If you invested \$10,000 into the EAFE, it would be worth just under \$29,000 over that same time frame.

No contest: U.S. versus International since the GFC

Growth of \$10K (3/6/2009 – 8/30/2019)



Source: Morningstar

Americans are occasionally mocked for their provinciality. To the extent this particular character defect has found expression as home country bias within their equity portfolios, it has (at least over the past ten years) proven to be financially beneficial one!

Even over a longer time frame, the outperformance of U.S. equities is hard to ignore. If one had made an investment at the beginning of any year within the last 40 years, and then held it through year end 2018, there is not a single year in which one would have been better off investing in the EAFE instead of the S&P 500. On a compounded basis from year end 1978 through year end 2018, the S&P 500 outperformed by a rather stunning 3.8% annualized.

Just Buy American?

Could American exceptionalism be systematically undervalued?

Given this long-term performance backdrop, we've heard many explanations as to why investors should not even bother looking outside the United States. These include better corporate governance and shareholder orientation, a superior culture of innovation and entrepreneurship, a relatively benign regulatory/taxation environment, favorable demographics, and military and economic supremacy.

The United States does indeed have many attractive attributes as a jurisdiction for investment. It is at least conceivable that some of these intangible benefits are consistently underappreciated in equity valuations—leading to what financial theory might regard as a systematic inefficiency. Pushing forward on this train of thought, if U.S. equity markets have outperformed because investors fail to recognize the advantages of being domiciled in the United States—this creates the potential for sustained outperformance versus investor expectations and superior returns.

While investors may be tempted to declare eternal victory for U.S. stocks, does the data really suggest we should?

Anchoring our perspective to the past decade or so favors U.S. equities heavily, but looking at performance data from other angles may produce a more balanced picture. Since 1979, the S&P 500 has only outperformed the EAFE in 23 out of 40 years and 10 out of the past 20 years. It is also worth noting that the post-GFC experience was preceded by a phase in which international equities significantly outperformed. From 2002 through 2007, the EAFE beat the S&P 500 for six years in a row. On a compounded basis, this outperformance was a hefty 8.8% per year.

U.S. versus International since the "tech wreck"

Calendar Year	Total Return (%)			Cumulative Annualized Relative Returns (%) from 12/31/01
	MSCI EAFE	S&P 500	Difference	
2002	(15.6)	(22.1)	6.5	6.5
2003	39.3	28.7	10.6	8.3
2004	20.7	10.8	9.9	8.8
2005	14.1	4.9	9.2	8.9
2006	27.0	15.8	11.2	9.3
2007	11.7	5.6	6.1	8.8
2008	(42.9)	(36.9)	(6.0)	5.5
2009	32.6	26.4	6.2	5.6
2010	8.3	15.1	(6.7)	4.3
2011	(11.7)	2.1	(13.8)	2.3
2012	17.9	15.9	2.0	2.3
2013	23.4	32.4	(8.9)	1.5
2014	(4.3)	13.7	(18.0)	(0.0)
2015	(0.3)	1.4	(1.7)	(0.2)
2016	1.6	11.9	(10.3)	(0.8)
2017	25.7	21.8	3.9	(0.6)
2018	(13.3)	(4.4)	(8.9)	(1.2)
Simple average:	9.4	10.3	(0.5)	
Compounded since 12/31/01:	5.7	6.8	(1.2)	

Denotes EAFE underperformance

Source: Bloomberg, as of December 31, 2018.

*Global equity markets
"re-based" in 2002 – making
the year an interesting
starting point to measure
returns*

Calendar year 2002 represents an interesting starting point to consider, as it marked the end of an extended period of value destruction and arguably a "re-basing" of stock market valuations. Global equity markets bottomed in the fall of 2002, following the collapse of the tech bubble and the September 11th attacks. (Worth mentioning, the S&P 500 and the EAFE delivered similarly awful total returns from 2000 through 2002, respectively -37.6% and -42.5%.)

Viewed from the prism of the past 17 calendar years (2002 through 2018), the war of returns between U.S. and non-U.S. equities appears more even. From 12/31/2001 to 12/31/2018, the S&P 500 outperformed the EAFE by a more subdued 1.2% annualized (6.8% versus 5.7%). In fact, using year end 2001 as the starting point, it would not be until early 2016 that S&P 500 cumulative returns would permanently surpass those of the EAFE (at least through the publication of this piece). From 2002 through 2018, U.S. equities on average outperformed by a moderate 0.5% per year and outperformed less than half of the time (8 out of 17 years).

*Not only is tech the largest
sector in the US, it has
dramatically outperformed*

Sector exposures are key to the story

A significant portion of the performance dispersion between U.S. and non-U.S. stocks appears driven by important underlying differences in industry sectors. The information technology sector stands out, both in terms of its much greater representation within the U.S. equity market, as well as the vastly superior performance of U.S. tech stocks.

For the 10 year period ending August 30, 2019, we compare the underlying contributions by industry sector of the MSCI EAFE with the MSCI USA Index. (The MSCI USA Index closely resembles the more commonly referenced S&P 500 Index, but utilizes the same industry classification methodology as the MSCI EAFE Index, which facilitates comparisons.)

MSCI EAFE versus MSCI USA (Aug 31, 2009 – Aug 30, 2019)

	Est. Contribution to			Average Weight			Est. Total Return		
	EAFE	USA	Δ	EAFE	USA	Δ	EAFE	USA	Δ
Total	70.4	253.3	(182.9)	100.0	100.0	-	70.4	253.3	(182.9)
IT	4.4	55.4	(51.0)	4.7	17.3	(12.6)	109.1	392.6	(283.5)
Health Care	11.6	35.3	(23.7)	10.3	13.6	(3.4)	141.7	281.9	(140.2)
Comms. Serv.	4.4	27.6	(23.1)	6.6	9.0	(2.5)	62.7	378.9	(316.3)
Financials	4.7	25.2	(20.5)	20.9	13.3	7.6	16.9	159.0	(142.1)
Consumer Disc.	9.8	28.3	(18.5)	10.7	8.9	1.7	111.4	407.5	(296.1)
Industrials	11.8	25.7	(13.8)	13.0	9.8	3.2	102.2	265.4	(163.1)
Consumer Staples	13.2	22.1	(8.9)	10.9	9.1	1.8	151.1	221.0	(69.9)
Energy	2.0	9.4	(7.4)	6.6	8.9	(2.4)	24.3	34.0	(9.8)
Utilities	0.7	7.1	(6.4)	4.0	3.1	0.9	21.9	203.3	(181.3)
Real Estate	3.0	7.2	(4.2)	3.5	2.7	0.8	90.8	305.0	(214.2)
Others	0.6	3.7	(3.2)	0.5	1.0	(0.5)	77.4	202.4	(125.0)
Materials	4.1	6.5	(2.3)	8.5	3.3	5.3	42.6	155.3	(112.7)

Source: Bloomberg, as of August 30, 2019.

According to this data, over one-quarter of the outperformance of U.S. equities (51% out of 183%) was driven by the IT sector, which represented on average 17% of the U.S. equity market, versus less than 5% outside the U.S. The IT sector also delivered a ten year total return (393%) that was more than 50% greater than the overall U.S. market (253%).

The IT sector plus FAANGs outside of IT appear to have driven about 40% of US outperformance over the past decade

While the market leadership of the large cap technology platform stocks (aka the FAANGs) is well understood, several of these stocks are not classified by MSCI as information technology. By our estimates, FAANG stocks classified within the other high flying sectors of the U.S. market, Consumer Discretionary and Communication Services, respectively represented about 24% and 38% of those sectors' contribution to total U.S. returns. Including these stocks along with the IT sector as contributors to the performance differential would bring the overall contribution of "tech and tech platform" companies to U.S. outperformance closer to 40%.

Currency moves also play an important role

For a variety of reasons, it is extremely difficult to tease out what portion of equity market returns one can attribute to currency moves. Broadly speaking, however, stocks based in a country with a declining currency tend to underperform (on a same currency basis) stocks based in a country with an appreciating currency.

US dollar strength could explain up to another 25% of US outperformance

To approximate the impact of currency depreciation on EAFE returns, we calculated the total return of the five major currencies represented within the EAFE index for the ten year period ending 8/30/2019. On a weighted average basis (using country of domicile weightings at year end 2018), we estimate that the major EAFE currencies depreciated by approximately 16% relative to the U.S. dollar. Reversing the negative effect of this level of currency depreciation on EAFE cumulative returns, we calculate EAFE annualized returns would have been 2.6% versus 1.0%. The differential between the S&P 500 and the EAFE would accordingly be reduced from 6.3% to 4.7% — in other words, by approximately one-quarter of the total performance differential.

While there is perhaps a fascinating debate to be had about how to separate currency fluctuations from equity market returns (or whether one should even try to do so), the broader point is that U.S. equity outperformance appears to have been significantly flattered by the strength of the U.S. dollar relative to other currencies since the financial crisis. By the same token, it should be noted that the six year stretch (2002-2007) in which the EAFE outperformed the S&P 500 by a whopping 8.8% annualized was accompanied by a 64% appreciation of the Euro, 18% appreciation of the Japanese Yen, and 36% appreciation of the British Pound relative to the U.S. dollar.

While the subject is immensely complex, a comparison of performance data between U.S. and non-U.S. equities leads, in our view, to a few inferences that are difficult to refute:

- Over the past decade, U.S. equity markets have delivered far superior returns; this phase of U.S. outperformance significantly impacts much longer term performance calculations.
- There have been phases historically when non-U.S. stocks have dramatically outperformed as well, including one that just preceded the boom in U.S. equity markets.
- The returns of U.S. technology (and tech platform) companies have been extraordinary since the financial crisis; non-U.S. equity markets barely participated in this phenomenon.
- The relative strength of the U.S. dollar appears to have flattered U.S. equity market returns.

As our lives have become engulfed by the products and services of the very companies that have fueled U.S. equity outperformance, it is easy to think the next decade will resemble the last

Years of underperformance outside the US have potentially left bargains in their wake.

Where do we go from here?

We believe investors should resist the temptation to discriminate against non-U.S. equities and maintain an open-minded, global perspective toward opportunities across equity markets. We would highlight the following points to consider:

- *Is it reasonable to rely on a sustained continuation of the trends that have driven U.S. outperformance?* Over the past 10 years, the U.S. IT sector delivered a total return of nearly 400% (or more than 17% annualized). The five stocks with the largest weightings in the MSCI USA Index as of August 30, 2019 (each of them an IT or tech platform stock, representing in aggregate approximately 15% of the index) delivered average total returns over the prior ten years in excess of 900%.

- *What is the benefit of limiting your opportunity set?* Despite the massive outperformance of U.S. equities, approximately 39% of the MSCI World Index by market capitalization remains non-U.S. equities as of August 30, 2019. Remarkably this figure was 53% as of August 31, 2009. If markets are thought to be inefficient, it follows that investors should seek the broadest menu of potentially mispriced securities.

- *Having selective exposure to non-U.S. equities does not prohibit you from owning U.S. equities.* We calculate that nearly half (approximately 47%) of the stocks included in the MSCI USA Index actually underperformed the EAFE between August 31, 2009 and August 30, 2019. If the argument against international equities is their poor performance, it is logically inconsistent to prioritize consideration of lower performing U.S. equities over the entire universe of non-U.S. equities.

- *Income-oriented investors have a number of compelling reasons to stay involved with international stocks.* Not only is the dividend yield of the EAFE (3.5%) much higher than the S&P 500 (1.9%), high dividend stocks in the U.S. tend to be clustered within a few (typically rate sensitive) sectors.

- *Inclusion of international equities may improve portfolio diversification and lead to superior risk-adjusted returns.* While U.S. investors seemed to benefit significantly from tax reform in 2017, the incumbent U.S. President could be succeeded by a candidate with vastly different ideas about taxation, business regulation and the treatment of capital.

Value investing and modern portfolio theory may align here

However dimly one might regard the efficient market hypothesis—to believe that U.S. equities will continue to outperform similarly risky foreign equities indefinitely into the future is to buy into a market anomaly of extraordinary proportions. While value investors tend to be among the harshest critics of academic finance, they should nonetheless be similarly skeptical. Value investors tend to believe good investment performance can lead to excessively positive sentiment and over-valuation; poor performance works in the opposite direction. As Ben Graham wrote: “The intelligent investor is a realist who sells to optimists and buys from pessimists.”

MSCI EAFE vs. S&P 500: 40 year Scorecard

Calendar Year	Total Return (%)			Cumulative Annualized Relative Returns (%) from 12/31/78
	MSCI EAFE	S&P 500	Difference	
1979	1.8	18.6	(16.8)	(16.8)
1980	19.0	32.4	(13.4)	(15.3)
1981	(4.8)	(4.9)	0.1	(9.5)
1982	(4.6)	21.5	(26.2)	(13.7)
1983	20.9	22.6	(1.6)	(11.5)
1984	5.0	6.3	(1.2)	(9.7)
1985	53.0	31.7	21.2	(6.2)
1986	66.8	18.7	48.1	(0.5)
1987	23.2	5.3	17.9	1.6
1988	26.6	16.6	10.0	2.4
1989	9.2	31.7	(22.4)	0.2
1990	(24.7)	(3.2)	(21.5)	(2.2)
1991	10.2	30.4	(20.2)	(3.6)
1992	(13.9)	7.6	(21.5)	(5.1)
1993	30.5	10.1	20.4	(3.5)
1994	6.2	1.3	4.9	(2.9)
1995	11.6	37.5	(25.9)	(4.1)
1996	6.5	22.8	(16.4)	(4.8)
1997	2.2	33.3	(31.1)	(6.2)
1998	20.4	28.6	(8.1)	(6.3)
1999	27.8	21.0	6.8	(5.7)
2000	(13.8)	(9.1)	(4.7)	(5.6)
2001	(21.0)	(11.9)	(9.1)	(5.9)
2002	(15.6)	(22.1)	6.5	(5.2)
2003	39.3	28.7	10.6	(4.6)
2004	20.7	10.8	9.9	(4.1)
2005	14.1	4.9	9.2	(3.6)
2006	27.0	15.8	11.2	(3.1)
2007	11.7	5.6	6.1	(2.8)
2008	(42.9)	(36.9)	(6.0)	(3.0)
2009	32.6	26.4	6.2	(2.7)
2010	8.3	15.1	(6.7)	(2.9)
2011	(11.7)	2.1	(13.8)	(3.3)
2012	17.9	15.9	2.0	(3.1)
2013	23.4	32.4	(8.9)	(3.3)
2014	(4.3)	13.7	(18.0)	(3.7)
2015	(0.3)	1.4	(1.7)	(3.6)
2016	1.6	11.9	(10.3)	(3.8)
2017	25.7	21.8	3.9	(3.6)
2018	(13.3)	(4.4)	(8.9)	(3.8)
Simple average:	9.8	12.8	(3.0)	
Compounded since 12/31/78:	7.71	11.51	(3.8)	

Denotes EAFE underperformance

Source: Bloomberg, as of August 30, 2019.

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The views expressed are those of the portfolio manager as of October 2019, are subject to change, and may differ from the views of other portfolio managers or the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice.

Sources for all data: JOHCM/Bloomberg (unless otherwise stated).