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Global Value and Income Dispatch

US equity investor xenophobia: is it justified?

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

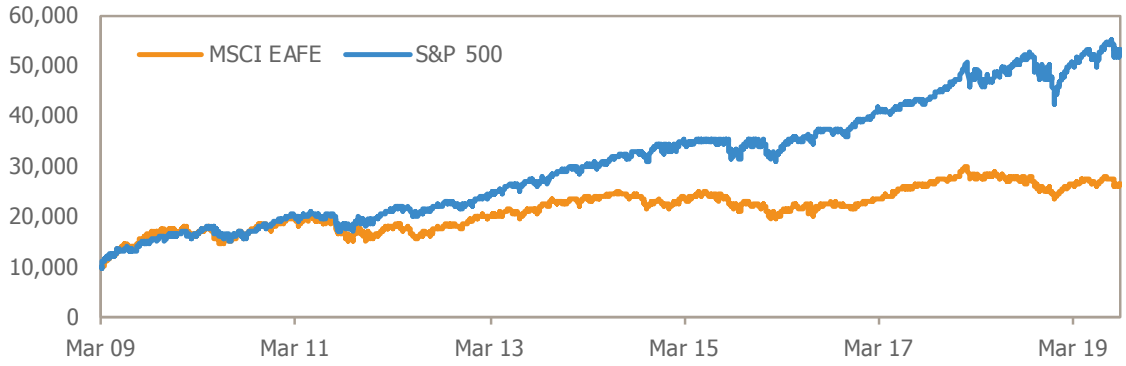
Investors who were sufficiently clairvoyant to put money to work on the worst day of the Great Financial Crisis (March 6, 2009) have been amply rewarded as global capital markets have recovered and grown. But those who bought US stocks received the lion's share of the rewards. If you invested $10,000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

Investors are losing patience with underperforming global ex US equities

US tech stocks and dollar strength largely account for the divergence

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

No contest: US stocks versus International stocks since the GFC



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!

Could American exceptionalism be systematically undervalued?

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

Just buy American?

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 US equity markets have outperformed because investors fail to recognise the advantages of being domiciled in the United States—this creates the potential for sustained outperformance versus investor expectations and superior returns.

Anchoring our perspective to the past decade or so favors US 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.

US versus International since the "tech wreck"

Calendar	Total Return (%)			Cumulative Annualized Relative Returns (%)
Year	MSCI EAFE	S&P 500	Difference	from 31/12/01
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 31/12/01:	**5.7**	**6.8**	**(1.2)**	

Source: Bloomberg as at 31 December 2018. Denotes EAFE underperformance

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%.)

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

Viewed from the prism of the past 17 calendar years (2002 through 2018), the war of returns between US and non-US equities appears more even. From 31/12/2001 to 31/12/2018, 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, US equities on average outperformed by a moderate 0.5% per year and outperformed less than half of the time (8 out of 17 years).

Sector exposures are key to the story

A significant portion of the performance dispersion between US and non-US 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 US equity market, as well as the vastly superior performance of US 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 Return (%)			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)

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

Source: Bloomberg as at 30 August 2019.

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

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 US market, consumer discretionary and communication services, respectively represented about 24% and 38% of those sectors' contribution to total US 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 US outperformance closer to 40%.

Currency moves also play an important role

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

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.

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 30/8/2019. 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 US dollar. Reversing the negative effect of this level of currency depreciation on EAFE cumulative returns, we calculate EAFE annualised 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 US equity outperformance appears to have been significantly flattered by the strength of the US 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% annualised 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 US dollar.

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

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

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

Where do we go from here?

- We believe investors should resist the temptation to discriminate against non-
- US 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 US outperformance? Over the past 10 years, the US IT sector delivered a total return of nearly 400% (or more than 17% annualised). The five stocks with the largest weightings in the MSCI USA index as of 30 August 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 US equities, approximately 39% of the MSCI World index by market capitalisation remains non-US equities as of 30 August 2019. Remarkably this figure was 53% as of 31 August 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-US equities does not prohibit you from owning US equities. We calculate that nearly half (approximately 47%) of the stocks included in the MSCI USA Index actually underperformed the EAFE between 31 August 2009 and 30 August 2019. If the argument against international equities is their poor performance, it is logically inconsistent to prioritise consideration of lower performing US equities over the entire universe of non-US 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 US tend to be clustered within a few (typically rate sensitive) sectors.

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

Value investing and modern portfolio theory may align here

However dimly one might regard the efficient market hypothesis—to believe that US equities will continue to outperform similarly risky international 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 sceptical. 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	Total Return (%)			Cumulative Annualized Relative Returns (%)
Year	MSCI EAFE	S&P 500	Difference	from 31/12/78
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)**	

Source: Bloomberg as at 30 August 2019. Denotes EAFE underperformance

JOHCM Global Income Builder Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	30.09.19	30.09.18	30.09.17	30.09.16	30.09.15
A USD Class	-	-	-	-	-
MSCI World NR	-	-	-	-	-
Bloomberg Barclays US Agg	-	-	-	-	-
BofAML Glb HY Constr (BB-B)	-	-	-	-	-
IA Mixed Investment 20-60% Shares	-	-	-	-	-

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg Index Services Limited, NAV of Share Class A in USD, net income reinvested, net of fees. The A USD Class was launched on 30 April 2018. Performance of other share classes may vary and is available on request. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.