STOP LOOKING BACK:
A Forward-Looking Approach to International Equity Risk Allocation

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The most common thesis for what constitutes “the new normal” embraces several primary ideas: lower economic growth rates due to structural imbalances and de-leveraging, reduced expectations for forward-looking asset returns, and episodic periods of volatility across increasingly linked global markets. This dim view of the future investment environment, introduced in the wake of the 2008 financial crisis, placed immense pressure on investors to find new ways to position portfolios for long-term capital growth while preparing for unknown levels of turbulence along the way.

This prevailing framework increased demand for more creative approaches to risk management and more discipline in designing and managing asset allocation strategies. If investors were to steer through a new economic reality while continuing to meet long-term obligations that required growth of capital, it was going to be through structured and purposeful allocation to a variety of asset classes and with a watchful eye on balancing emerging risks with long-term opportunities.

Amid all the uncertainty, the choices for sources of long-term capital growth amid all this uncertainty are not obvious. In the past, investors have relied on the historical safety of bonds. But with interest rates poised to rise from central bank liquidity-induced lows, bonds appear to be at the end of a 30-year bull run, so this fallback position has evaporated. U.S. equities are trading at moderate to high historical valuations—depending on the metric used—following a strong recovery over the past few years. One needn’t look far to see where growth is occurring in the rest of the world. It is the balancing of risks to gain access to that growth that presents the challenge.

For investors seeking to diversify and access growth opportunities in equity markets outside the United States, the issue often becomes whether an active or passive approach presents the best route to success.

Advocates of the discretionary active approach—where an investment manager attempts to add value principally through stock selection—place confidence in the skill and proprietary insight of the manager to own a subset of companies contained in an index and pick the winners and avoid the losers. Additionally, proponents of active management argue that “less market efficiency” is another aspect to be exploited in many non-U.S. markets.

The long-term evidence highlights the difficulty of this task. The fact is that the majority of actively managed international equity funds fail to beat their reference-index benchmarks sustainably over time on a pre-tax basis, once the explicit cost of such strategies (management fees) and implicit costs (return dilution due to trading and turnover frictions) are taken into account. For taxable investors the hurdle is even higher, because the generally lower post-tax versus pre-tax return of such strategies further handicaps the likelihood of success versus a simple indexed approach.

Promoters of the passive indexed approach to international equity investing—whereby the investor simply owns the entire opportunity set of companies and countries in a cost- and tax-efficient manner—use the above logic to support their case. Unless an investor believes in the ability to pre-identify the minority of active managers that might beat the index consistently looking ahead, such logic is hard to refute.

Implications of Country Concentration Risk

A more fundamental question often goes unaddressed in the active versus passive debate, and it centers on country risk and its implications for investment allocations across countries.

The majority of passive international equity strategies rely on capitalization weighting to allocate across countries and their underlying companies as do most actively managed international equity strategies—which are benchmarked to such cap-weighted indexes. In the case of the latter, active managers often hew closely to index country weights seeking to reduce the risk of underperforming the benchmark while attempting to add value through individual company selection.

A deeper look at leading capitalization-weighted international equity indexes that guide both passive and active strategies raises two important considerations.

First, these indexes are concentrated in countries representing the minority of index constituents. For example, the MSCI All Country World Index ex-US (ACWI ex-US), contains exposure to 44 countries and allocates approximately one-third of the index weight to the top three countries...
(see figure 1). By the time you get to the tenth-largest country, close to three-quarters of the index’s allocation is accounted for. From a risk-management perspective, that would suggest significant concentration in single-country risk as well as a high degree of currency exposure concentration.

Second, delving into the concentrated group of countries that dominate exposure in cap-weighted international equity indexes reveals that they are principally represented by Japan and developed nations in Western Europe. In the ACWI ex-US Index, for example, such development-exposure exposures are close to 80 percent of the overall index, with developing countries representing the balance.

This should not be surprising, because the size of each country’s equity market is heavily influenced by the maturity of its economy and history of capital markets development. However, such concentration results in heavy exposure to countries that, in general, are experiencing low levels of economic growth, significant debt and deficit encumbrances, and are facing significant demographic and entitlement challenges ahead.

This is in stark evidence when considering the International Monetary Fund’s most recent World Economic Outlook and its projections for gross domestic product (GDP) growth across countries over the next five years. Mapping these GDP growth forecasts to current country weights in capitalization-weighted international equity indexes indicates that approximately 80 percent of such indexes are allocated to the countries that will generate 20 percent of world (excluding the United States) economic growth over the next five years; the remaining countries, representing 20 percent of such indexes, will generate 80 percent of the growth.

In addition, the higher-growth countries generally represent the mirror image of those in the 80 percent of market capitalization across key risk dimensions that can influence future rates of growth and the productivity of the private sector: lower levels of government debt, lower levels of...
deficits, lower government spending as a percentage of economic output, lower tax rates, higher rates of population growth, lower dependency ratios (i.e., population above the age of 65), and a lower median population age (see figure 2).5

Such countries also are making positive progress across economic freedom factors (such as those detailed in studies like the Heritage Foundation’s Index of Economic Freedom (http://www.heritage.org/index/), e.g., property rights, openness to trade, ease of starting businesses, pro-growth tax policy, etc.). Many developed countries that account for disproportionate allocations within the index have regressed along these dimensions in recent years.

A large number of developed countries facing slow economic growth and high unemployment also are undertaking extraordinary monetary policy measures, which may have negative future implications for inflation and currency values. Developing economies, in general, are applying more discipline in monetary policy than their developed-market counterparts.

In the fastest-growing segment of international markets, emerging countries are much earlier in the development cycle and are playing catch-up in technology adoption and infrastructure buildout. These countries present the likelihood of sustained higher economic growth and the expansion of a private sector and capital markets, starting from their low bases relative to developed economies.

In a report published in October 2013, McKinsey Global Institute outlined a rapidly changing business climate in developing market countries.6 The study found that emerging-market companies are often more nimble and faster-growing than their western counterparts, even when both operate in an emerging market where neither is based. In such markets, between 1999 and 2008, developing-market firms grew at a 30.7-percent annual clip, whereas developed-market rivals managed 12.6 percent.

According to the same report, emerging-market companies often were created to serve middle-class consumers in their home markets, and this knowledge is easily transferable. Chief executive officers at many developed-market companies are burdened by issues at home as well as by the demands of Wall Street. The report also forecasts that the number of companies generating more than $1 billion in annual sales will almost double in the next 10–15 years and that 70 percent of these new entrants will come out of emerging markets.

A recent analysis by Goldman Sachs estimated that the equity market capitalization of emerging countries will grow at a compound rate of almost three times that of developed countries over the next two decades.7 This estimate is based on estimated differentials between developed and developing countries in projected real earnings and dividend growth rates, equity market valuations, and currency exchange rates.

Investors must look beyond the status quo to manage risks and gain access to capital growth opportunities.

Toward a More Balanced International Equity Portfolio

In thinking through how to design a more balanced set of exposures to the international equity opportunity set, a variety of approaches can be considered. A starting point might be to conclude that developing-market exposure is too low and developed-market exposure too high and too concentrated in international equity indexes.

This might suggest applying some ad-hoc decision-making to reweighting countries in an international equity portfolio—say, putting half in developing markets and half in developed markets. Or, perhaps, just giving each country included in such a portfolio an equal weight.

Yet, these approaches are problematic. They don’t consider the differences in risk characteristics across countries and likely would result in a portfolio with an uneven allocation of risk across constituents. Such a portfolio would suffer from some of the concentration criticisms of a cap-weighting approach (Taliaferro 2012).

One potential solution is risk parity, an investment approach that recently has been gaining acceptance with institutional investors. The risk-parity conceptual framework is that a similar dollar amount invested across a series of assets can cause an unintentionally high concentration of risk. The example most often cited to explain risk parity is that of the 60/40 stock/bond portfolio, where the 60-percent equity allocation actually constitutes more than 90 percent of the portfolio’s risk, given the higher volatility of equities relative to bonds. A risk-parity strategy would seek to correct this imbalance by assigning new weights to the stock and bond components, so that each allocation is contributing equal risk to the overall portfolio.

A similar approach might be applied to investing across equity markets (Maillard et al. 2009; Hallerbach 2012). Certain countries, for instance, may have more liquid markets, diversification across industry sectors, and less sensitivity to a single risk factor such as changes in oil prices. Other countries may have less liquid markets with higher sector and stock concentrations.

Applying risk parity to international equity investing, however, suggests that using simple volatility to define a country’s risk may be misleading.8 For example, two countries with very different fundamental risk characteristics may have very similar volatilities during normal market windows yet exhibit material differences in downside vulnerability during periods of market turbulence.
From Concept to Implementation

In the design of a more forward-looking and risk-balanced international equity portfolio, one such strategy includes allocating capital according to the level of risk contributed to the overall portfolio by individual countries. Rather than using simple volatility as a measure of risk, the first process layer allocates a similar level of downside (or left-tail) risk contribution to each country in the index\(^9\) (Stoyanov et al. 2011; Xiong and Idzorek 2011).

The intended result is a more robust and diversified allocation of risk across the countries in the index.

This approach balances the allocation across developed and developing countries and improves the composite portfolio characteristics versus a cap-weighted approach. It does this by providing the following:

- Higher composite economic growth
- Lower composite government debt-to-GDP and composite deficit-to-GDP
- Lower composite government spending-to-GDP, lower composite tax burden-to-GDP, and lower composite marginal tax rates
- Improved composite demographics with respect to median age, population growth, and dependency ratios (population over the age of 65)
- Improving, versus regressing, composite measures of economic freedom (as measured by the Heritage Foundation’s Index of Economic Freedom)
- Higher composite corporate earnings growth
- Improved risk-adjusted return potential (see figure 3)

From a risk diversification perspective, the portfolio is less concentrated in individual countries and currencies than the cap-weighted approach.

De-Concentrating Company-Level Risks within Each Country

Another process point incorporated within the above strategy addresses concentration risk within each country. In some countries, single multinationals and/or state-controlled enterprises can account for a sizeable portion of capital allocation. In South Korea, for example, Samsung accounts for approximately 24 percent of the country’s equity market capitalization.\(^{10}\)

To address this additional source of concentration risk, these companies may be reweighted according to the risk contributed to the country’s overall risk profile. This approach reduces risk allocated to any single company and adds diversification across the portfolio. This may have the effect of improving exposure to companies that are serving consumers in emerging markets, for example, and decreasing exposure to larger, multinational, export-driven companies. In this approach, companies with higher relative risk of loss during an adverse market event are assigned lower weights and companies exhibiting relatively lower risk of loss are assigned higher relative weights, resulting in a more resilient and diversified country exposure relative to traditional capitalization-weighted single-country building blocks.

The Dynamics of Valuation and Corporate Fundamentals

The weighting scheme described above improves overall exposures, but relative country valuations at any point in time pose another layer of risk and opportunity. Key to managing valuation risk is a systematic and rules-based approach to reduce capital assigned to countries with richer valuations (after adjusting for fundamental risk) and into countries trading at more reasonable relative valuations. Such a systematic process incorporates valuation discipline into the process, adding an important layer of risk management and positioning the portfolio to take advantage of opportunities.

Similarly, over the short term, economic growth may or may not correspond with the dynamics of corporate fundamentals, another factor that must be managed. Each of these factors can be codified into the rules-based architecture, which effectively tilts away from countries in response to growing risks (higher valuations and deteriorating fundamentals) and toward countries...
with declining risks (lower relative valuations and improving or stable fundamentals). Codifying these rules helps guard against inherent biases and emotional decision-making—common pitfalls of many active managers and strategies.

An Investment Thesis for Long-Term Growth in the New Normal

Amid all the potential challenges inherent in the new normal environment and global equity investing, investors must look beyond the status quo to manage risks and gain access to capital growth opportunities. Within this context, an investment strategy that allocates capital across countries and companies according to risk (not merely size) and that emphasizes countries with stronger relative fundamentals trading at reasonable valuations (through a systematic, rules-based process) offers investors a risk-focused approach to international equity investing. This approach may offer at least one answer in a sea of questions about how to allocate capital in a new normal environment.

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Endnotes

1. The current median expense ratio for active international equity funds tracked by Morningstar is 1.28 percent.
2. Index constituent data are from FactSet as of September 16, 2013.
3. Country classifications obtained from MSCI as of September 16, 2013.

8. Simple volatility is the risk measure typically used to construct multi-asset class risk-parity portfolios.
9. Subject to liquidity tiers to ensure investability.

References