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Challenges to International Investing

By Matthew Peterson

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"You should increase your allocation to non-U.S. stocks" has been pretty common advice uttered to U.S. investors over the past few decades. Indeed, dedicated allocations to international stocks began growing in the 1980s with the adoption of mean-quantitative asset allocation techniques, first by institutional investors and then by individuals. Yet for many investors, the results have been disappointing. On the whole, U.S.-dollar-based investors have experienced neither increased returns nor a meaningful reduction in volatility as a result of these allocations.

But the prospect of adding value by investing overseas remains tantalizing, especially in the context of lowered expected returns for many asset classes.[1] Investors are blessed (or cursed) with a plethora of options, with increasing granularity based on geography, capitalization, and a raft of quantitative factors. As with domestic markets, there is robust debate about the extent to which new investment methodologies and implementation vehicles are impacting the markets themselves. Benchmark-sensitive investors need to evaluate index construction, particularly the growing importance of China in both the emerging- and developed-market benchmarks. Investors are facing great opportunities, but also great challenges, as they evaluate options for international investment.

This article introduces some of the issues global investors will encounter, based on my experience as an asset allocator and an international (primarily emerging-market equity) portfolio manager.

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CHALLENGE #1: DETERMINING INTERNATIONAL ALLOCATIONS

What is so compelling about international investing? The answer frequently boils down to the dynamic opportunity set, which has increased in size and scope as the economy has globalized. For example, the United States accounts for roughly only 25 percent of global gross domestic product (GDP), down from about 40 percent in 1960.[2] This relative decline has occurred as a result of emerging-market economies growing much faster than the U.S. and other developed economies. At the same time, the percentage of the global equity market as measured by the MSCI All Capital World Index (ACWI) represented by U.S. equities is now near its all-time high of 54 percent of index composition.

The United States is overrepresented in the capital markets. In other words, U.S. companies have twice the weight in global equity markets than the U.S. economy has in the global economy. Investors constructive on overseas investing suggest that the rest of the world may catch up, developing market structures conducive to increased equity investment. Skeptics, including important figures such as Warren Buffett, suggest that the overrepresentation signifies structural advantages to U.S. companies and markets that should be respected. The threshold challenge is merely the decision to have a dedicated international exposure at all.

ALTERNATIVE ALLOCATION CONSIDERATIONS

Portfolio managers increasingly are focused on a company's business operations when making investment decisions. For many companies, the official corporate address or primary market listing may have little to do with the underlying business. In 2016, 42.3 percent of S&P 500 companies' sales came from overseas.[3] The U.S. economy is less globalized than most of the rest of the world;[4] non-U.S. companies have an even higher percentage of revenue coming from outside their borders. More than 70 percent of the revenues from FTSE 100 companies come from outside the United Kingdom.[5] Investors often use equity investments in a country to benefit from economic growth in that country. But increasingly globalization frequently subverts that intention. Even within the United States, investors are reminded that they "invest in S&P, not GDP," re-emphasizing that it is ultimately company performance that drives investment results.

The opportunity set represented by non-U.S. companies is large and growing. Market-capitalization weighting is the most common, but it's not the only basis (and may not be the best) for asset allocation decisions. According to *Fortune's* 2017 Global 500[6] list, 14 of the top 25—and 64 of the top 100—companies are based overseas. The *Fortune* rankings are based on revenue, not on market capitalization, and therefore are somewhat less distorted by government ownership, investor access rules, etc. Investors are likely to continue to try to uncover winners overseas. Based on market activity over the past few decades, whether a geographically defined, market capitalization-based portfolio construct is the optimal methodology is questionable.

CHALLENGE #2: INVESTING IN AN ERA OF GLOBAL SKEPTICISM

"If you spend 15 minutes studying the economy, that is 10 minutes too much," said the famed U.S. investor Peter Lynch. He likely was referring to the domestic economy, but, consciously or not, many global investors have incorporated those words into their strategies. For many professional global investors, macro-based decision-making has fallen out of favor. That is not to say that macroeconomic considerations are irrelevant, but that most fund managers focus on bottom-up analysis, emphasizing fundamentals when making decisions.

Increased globalization may be one factor in this focus on stock picking. Since the end of World War II and the creation of the modern, post-Breton Woods global economic order, there has been increasing economic and financial market harmonization. Macro-factors have become less relevant by definition. The European Union (EU) and creation of the euro are the largest examples of this trend. Include the North American Free Trade Agreement (NAFTA), Mercosur (the South American trading block), and various agreements under the African Union, and the trend toward regionalization and globalization is evident.

CURRENCY HEDGING AND GLOBALIZATION

Perhaps the greater impact on globalization has been with regard to currency hedging. Relatively few global equity mutual funds actively hedge currency risk; rather they may take currency into account when evaluating a company. Japan is the only developed country in which investors appear eager to systematically hedge currency risk. Some global fixed-income funds hedge currency. But only a few do so beyond a blanket policy, rather than on a tactical basis. They either do or do not hedge, and then almost always on 100 percent of the portfolio. Global investors may wish to consider if the recent trend away from globalization, and particularly the challenges to the EU and the euro, militate for a more dynamic currency hedging policy.

Recent elections across Europe and the United States have expressed growing dissatisfaction with this trend. U.S. President Donald Trump made renegotiation of trade arrangements a keystone of his election campaign, a promise he fulfilled by withdrawing from NAFTA to spark that renegotiation. The United Kingdom currently is negotiating Brexit, its separation from the EU. In continental Europe, euro-skeptic parties are shaping both policy and politics, even when they are not winning parliamentary majorities. Remember that despite the eventual victory of a mainstream party in the 2017 French parliamentary elections, more than 40 percent of the votes cast in the first round of voting were for euro-skeptic parties. In Italy, the strongly anti-European Five-Star party won the plurality of votes in the 2018 parliamentary election. It remains unclear—Brexit notwithstanding—if the recent inability of euro-skeptic parties to win parliamentary majorities represents their electoral high-water mark, or if these are merely early battles in a more protracted war. However, even bottom-up investors should be taking some notice of storm clouds on the horizon.

One frustration of international investing is the modest connection between economic growth and stock market returns. It is intuitive—but wrong—that countries with higher economic growth rates should have greater stock market returns.[7] Yet, very often the risks inherent in international investing come from country-specific macroeconomic causes; examples include Greece (systemic debt), Venezuela (poor economic policy), United Kingdom (Brexit), etc.

Investors need to increase their focus on corporate fundamentals and downplay macroeconomics when evaluating overseas opportunities. Yet at the same time investors may need to increase their focus on macroeconomic and geopolitical factors when evaluating risk. This challenge implies different skill sets—and mindsets—within the same firm. Opportunities usually are represented by a range of outcomes (earnings ranging between x and y) but risks are often binary (elections, defaults, even war).

CHALLENGE #3: IMPORTANCE OF THE U.S. DOLLAR

Relative performance of international versus domestic equity portfolios is greatly influenced by the performance of the U.S. dollar relative to foreign currency. In fact, this relationship is strongly negatively correlated—a stronger dollar generally leads to superior returns on U.S. equities for dollar-based investors, and a weaker dollar generally leads to inferior returns on U.S. equities for dollar-based investors (see figure 1). The correlation between relative performance of both the MSCI EAFE and Emerging Market (EM) indexes to the U.S. dollar is approximately −0.58 for both indexes.[8]

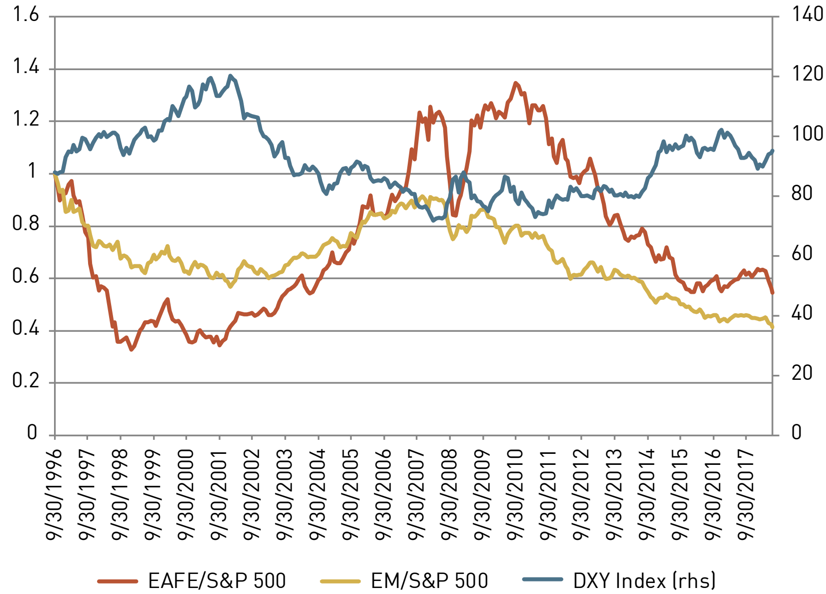
Investors have some important decisions to make regarding currency. Given its importance in determining relative returns and the current changes in the geopolitical order, should currency management be reconsidered? If so, should hedging be done on a strategic or tactical basis? Given the costs and liquidity constraints, hedging is generally possible only on developed-market and select emerging-market currencies.

Figure 1

RELATIVE PERFORMANCE AND U.S. DOLLAR

LEFT-HAND SCALE REPRESENTS RELATIVE PERFORMANCE (MONTHLY) OF THE S&P 500 INDEX VERSUS THE MSCI EAFE AND EMERGING MARKETS INDEXES, RESPECTIVELY, IN U.S. DOLLARS.

RIGHT-HAND SCALE IS DXY INDEX IN U.S. DOLLARS.



Source: Bloomberg as of June 30, 2018

CHALLENGE #4: INDEX CONSTRUCTION AND THE RISE OF CHINA

Index providers have great influence over how both active and passive participants invest money. In a very real sense, index providers create the opportunity set; a company's inclusion in the index creates demand for its shares. Index construction is a much more dynamic process globally compared to domestic markets. The constituents of the major domestic indexes are fairly static, with turnover on the S&P 500 Index at just more than 4 percent. Most major changes in the index are due to market forces, not decisions from the index providers.[9]

In contrast, changes to international and especially emerging-market equity indexes have tended to be longer-term and more (but not always) systemic. Countries gain and lose status in the global markets, moving across developed, emerging, and frontier status. Some of these changes are due to overt changes in government policy; other changes are the result of significant economic events. These secular changes have occurred most frequently in the emerging markets, with the 2013 downgrade of Greece to emerging-market status being an exception. However, with Brexit and further challenges to the EU and the euro, will additional structural changes follow?

IS CHINA THE NEXT JAPAN?

The biggest challenge to active investment managers with international mandates, and especially with emerging-market ones, is almost certainly the increasing importance of China. China entered the MSCI EM index with a fractional weighting in 1993 consisting entirely of H shares—stocks listed on the Hong Kong exchange. Chinese stocks now make up more than 30 percent of that index. The index's weighting of Chinese stocks will grow with the recent decision by MSCI to include A shares—shares of companies listed in the Chinese mainland—alongside the H shares. As with China's initial inclusion in the index, the immediate impact of A-share inclusion on the index and on shares of the companies themselves is minimal at less than 40 basis points of actual index impact. Yet simply announcing the names of these 234 companies has increased their visibility to the investment community. It is estimated that if these companies were included in the index at their full market-capitalization weight,[10] the total weight to Chinese companies in the MSCI Emerging Markets Index would grow to more than 40 percent. Should either South Korea or Taiwan be promoted to developed-market status, that figure would jump to 50 percent or even higher.[11]

China also is having an impact on broad market indexes; Chinese stocks represent 6.2 percent of the MSCI All Cap World Index (ACWI) ex USA, the third-largest country after Japan and the United Kingdom. Including non-mainland Hong Kong shares, this figure is more than 9 percent. Chinese stocks make up 3.7 percent of the All Cap World Index, again roughly 5 percent including non-mainland Hong Kong shares. Assuming eventual inclusion of mainland shares, the China weighting in these indexes will double, and China will become the second- or third-largest country, after the United States and Japan.

China's increasing weightings in the indexes has been largely the result of expansion of the Chinese economy, creation of capital markets, and liberalization of cross-border investing rules. These are all macroeconomic factors, and none are guaranteed for the future. The same common factors that contributed to the growth of the Chinese equity market (and subsequent index inclusion) can be thrown into reverse.

INVESTMENT CONSIDERATIONS

Global investors face the same active-passive debate as domestic ones. Approximately 30 percent of assets invested in the domestic markets are directly invested in passive products, but the percentage of international assets invested passively is less than half that. The theoretical underpinnings of passive investing seem questionable overseas, especially given the degree of interference in overseas equity and currency markets. Given that index providers must make qualitative decisions, is there really such a thing as passive global investing? Or is there a series of active decisions being made, with the only question being who is making them?

The large allocation to Chinese stocks presents challenges for both passive and active investors. Passive investing assumes a high degree of market efficiency; any given stock should have an allocation in a portfolio based on its market weighting. Is that underlying assumption valid with respect to Chinese shares? China is not a traditional market economy; the government actively manages both the economy and the equity market. China is not the only country that intervenes in its economy and equity market; the Bank of Japan owns about 4 percent of the Japanese equity market. But Chinese government interference is more frequent, more tactical, and has greater impact on the global equity markets. Do even the most ardent indexers truly feel confident in large and growing allocations to Chinese equities?

Active managers, especially those with dedicated emerging-market mandates, have a different challenge (or perhaps opportunity) due to China's increasing index weight. Getting China right will go a long way to ensuring outperformance over a benchmark; getting it wrong may prove fatal. This is likely to be true regardless of whether a portfolio's China allocation represents an active decision by the portfolio manager or is the result of bottom-up decisions.

From an index perspective, China is starting to look like Japan did in the 1980s. Japanese stock weightings in the EAFE Index have varied greatly during the indexes' history, from a 30-percent index weight in 1980, to nearly 60 percent by the end of the decade at the height of the Japanese economic and market bubble, to about 20 percent today. At the end of the 1980s, the Japanese allocation in the MSCI World Index was greater than that of the United States. For years after the Japanese equity market bubble popped in 1989, international managers that were underallocated to Japanese stocks almost were guaranteed superior performance, regardless of stock picking. Managers that were overweight Japan generally could not overcome that allocation.[12] Decades from now, will we be saying the same thing about China?

THE FINAL CHALLENGE

Recent underperformance of international stocks relative to domestic markets has not dampened interest in overseas investing. However, market returns and changes to the global economy are spurring investors to reconsider long-held asset allocation tenets. Has the problem been with the markets or with the way they have been accessed? As companies become more global, shouldn't portfolio allocation guidelines become more global as well? Are regional investments based on corporate domicile and market capitalization weighted rubrics necessarily the optimal way to invest overseas? Changes to the macroeconomic environment and issues involved in index-construction decisions suggest not. Many other articles in this issue of *Investments & Wealth Monitor* will suggest newer, different ways to access global markets in the search to realize the potential of these investments.

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ENDNOTES

1. A good primer can be found at www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/why-investors-may-need-to-lower-their-sights.
2. See www.worldbank.com.
3. See us.spindices.com/indexology.
4. The World Bank estimates that in 2016, 27 percent of U.S. gross domestic product was represented by gross trade (imports and exports), compared to 83 percent for the EU.
5. See www.ftserussell.com.
6. See www.fortune.com.
7. Literature abounds on this issue. A good summary can be found in "Is There a Link Between GDP Growth and Equity Returns?" MSCI Barra Research Bulletin (May 2010), https://www.msci.com/documents/10199/a134c5d5-dca0-420d-875d-06adb948f578 May 2010.
8. Computed by taking the average of 36-month rolling correlations from September 1997–June 2018.
9. Granted, the recent changes to S&P's Global Industry Classification Standard, through which companies are assigned to one of the 11 sectors, has had a significant impact on how the markets are viewed.
10. MSCI adjusts a company's weighting in the index based on the value of its floated shares. For a full discussion of Chinese inclusion, see *China A Shares Inclusion, March 2018,* https://www.msci.com/documents/1296102/1330218/CNA_Incl_QA.pdf/acc8b584-ccec-4483-958f-fc2f558ddb1a.
11. Note that China is already 36 percent of the FTSE Emerging Markets Index, because FTSE already has promoted South Korea to developed-market status, but it has not included Chinese A shares yet.
12. In full disclosure, I published an article on this fact in the IMCA *Monitor*, a predecessor publication to this one, in the late 1990s: "International Active Management: Sources of Return and Sources of Difficulty," *The Monitor* (vol. 14, no. 2, March/April 1999). The impact of Japanese allocations in EAFE mandate portfolios can be found in Richard A. Ferri, "Foreign Funds Don't Measure Up," *Forbes* (April 8, 2010), https://www.forbes.com/2010/04/08/foreign-managed-mutual-funds-benchmarks-personal-finance-indexer-ferri.html#740e033a5e86.

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