Rationally Behavioral:

The Case for Non-U.S. Equities

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DeMarche

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Points of Discussion

Abstract

Despite underperformance during the most recent market cycle, the case for actively managed non-U.S. equity investing remains strong and goes beyond simple diversification benefits. Institutional investors that are able to overcome their behavioral biases toward non-U.S. investing may be poised to reap improved risk-adjusted results over the long term. Non-U.S. equities can improve portfolios by accessing the sector diversification, demographic trends, market and macroeconomic characteristics, and currency diversification that exist outside of our domestic market.

The recent rebound in international stocks has been welcomed, but is it enough to sway weary investors to stay the course with non-U.S. exposure?

Recent Non-U.S. Struggles

Many years of underperformance by non-U.S. markets relative to domestic markets have investors raising the issue of international returns not measuring up to expectations. As of 3/31/2021, the one-year return for the U.S. market (Russell 1000) held a 16 percentage point differential over the MSCI EAFE, wider than the 10-year return differential of 8.5 percentage points. Plan fiduciaries and investment committee members, for example, are questioning allocations to the developed and/or Emerging Market asset classes, while other investors are acknowledging underperformance by pulling money outright. In 2020, international equity funds' net outflow of $63 billion ($98b out [active] versus $35b in [passive]) surpassed the 2008 record of $53 billion, set during the global financial crisis.[1]

Defined Contribution Plan Sponsors have also demonstrated a lack of enthusiasm for non-U.S., as the Deloitte 2019 DC Survey indicates that 40% of Plan sponsors did not offer Emerging Market funds within their lineup and plan participants chose to invest primarily in domestic assets. Within plans that offered active and passive, global, international, and Emerging Market funds, the median total allocation across those sectors was only 8.5%.[2]

While performance and flows out of the international markets have been cause for heightened concern, DeMarche continues to support the asset class's diversification benefits, in conjunction with other factors cited in the next section, as reasons to hold international stocks. We do recognize that due to globalization, non-U.S. and domestic asset class correlations have increased over time, implying less diversification, particularly during times of market stress (i.e., 2008 financial crisis). However, long periods of rotating under/over performance from U.S. markets, relative to non-U.S. markets, continue to demonstrate the variability and cyclical nature of returns across these two broad asset classes.

[1] Morningstar U.S. Fund Flows Commentary, December 2020
[2] Deloitte 2019 Defined Contribution Benchmark Survey Report

Behavioral Biases

First, we focus on overlooked behavioral biases that may impede investors from seeing the benefits of non-U.S. investing going forward. John Maynard Keynes suggested that much of economic activity is driven by animal spirits, those non-economic motives that are the main cause of economic fluctuations and of which create manias and panics (bull and bear markets). The following behavioral biases may impact investors' pessimism about non-U.S. investing.

Confirmation Bias – implies that we give a lot more weight to information that confirms our current beliefs (and experience) and less weight to information that does not support our beliefs. The past 10-year period of strong U.S. market performance may cause investors to be biased against non-U.S. investments, even considering new information. A second example of confirmation bias may be the "home bias," or predisposition of U.S. investors to invest only in the U.S. markets.

Availability Bias – we tend to judge the frequency of an event by its ease of recall. An emotional event is easier to remember than a non-emotional event. We also judge the emotional event as being more numerous, or happening more often, than the non-emotional event. In this example, the *prior* 10-year period (June 2000 to June 2010)[3] in which non-U.S. markets outperformed U.S. markets is not easily recallable. The past positive perspective about non-U.S. investing has been replaced with the more recent enthusiasm concerning U.S. and domestic growth markets.

Overconfidence Bias – we assume we know everything there is to know about a given topic, resulting in the failure to explore different opportunities or better solutions. For example, the technology and communication services sectors have driven U.S. returns for several years. In 2020, Facebook, Apple, Amazon, Netflix, Google (FAANG), Tesla, and Microsoft accounted for two-thirds of the R1000 index's return. Tech makes up 28% of the R1000 and about 9% of the MSCI EAFE as of 12/31/2020,[4] and it is one of the key reasons for recent underperformance relative to domestic markets. Understandably, we extrapolate (another behavioral bias) the outstanding performance of U.S. technology companies well into the future. However, digitalization technology, a phenomenon expected to impact many different industries and sectors worldwide may be a game changer for some countries. For example, The Tufts University and Mastercard digital evolution scorecard tracks analyses of 90 global economies. The authors of the scorecard call the "new GDP" a country's gross *data* product. "Once they've begun to understand their new GDP, economies can begin to unlock its full value…."[5] The assumption that U.S. markets will continue to be driven primarily by technology, and that the best technology companies are U.S. companies only, could be an example of overconfidence.

Emotional Biases

In addition to the cognitive biases discussed previously, emotional biases may be a factor in investor concerns about international investing:

Loss-Aversion Bias – we want to avoid feeling loss, as it hurts twice as much to lose an amount of money as it feels good to win the same amount. Therefore, if an asset class has been underperforming for a period of time, it becomes more challenging to stay invested or rebalance to a target allocation.

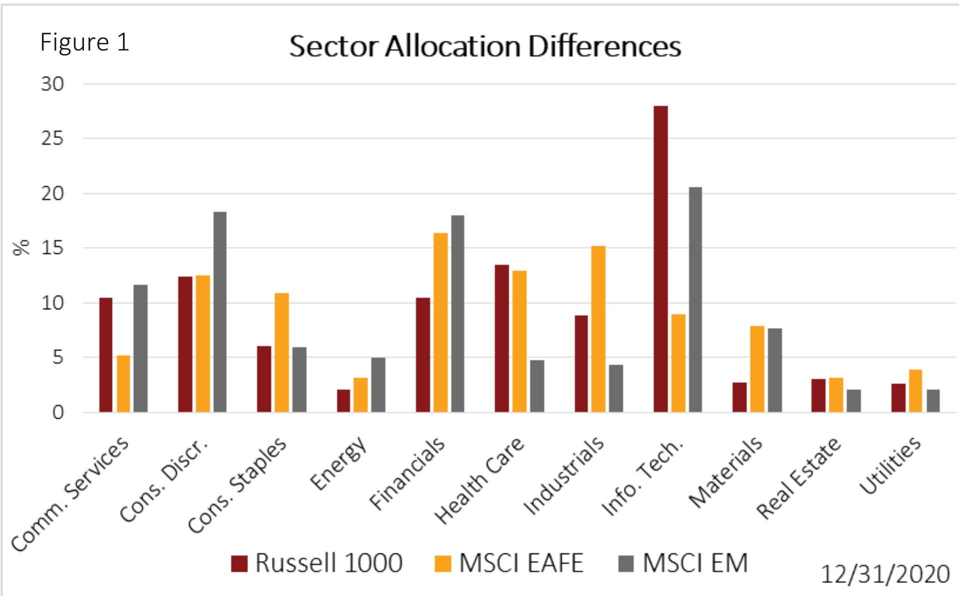
Regret-Aversion Bias – occurs when we fear that taking action will, in hindsight, turn out to be the wrong decision. Human beings want to avoid feeling regret at all costs and prefer sure outcomes. Domestic markets and growth have been the

[3] DeMarche, Capital Market Review, June 30, 2020
[4] DeMarche, Capital Market Review, December 31, 2020
[5] Harvard Business Review, Economics & Society, December 18, 2020;
Which Economies showed the Most Digital Progress in 2020? By Bhaskar Chakravorti, Ajay Bhalla, and Ravi Shankar Chaturvedi

"sure bet" over the recent past, which may elevate the fear of regret, resulting in not taking action or taking inappropriate action when it comes to non-U.S. investing.

Portfolio Diversification from Non-U.S. Markets

While the behavioral biases may hold an investor away from making or maintaining an allocation to non-U.S. markets, a variety of arguments for why it may be helpful for a portfolio are important to discuss. The most cited argument is diversification, which helps to smooth the return stream of a portfolio over time because different segments of the investment markets do not move perfectly together. This can also improve risk statistics and thus the risk/return profile of a portfolio's performance. Most institutional investors are advocates of a diversified portfolio, and accessing non-U.S. markets can help achieve that goal.



Looking beyond the return streams themselves providing diversification, expanding into non-U.S. markets provides exposure to other return drivers. From the perspective of sector allocations, the Russell 1000, MSCI EAFE, and MSCI Emerging Markets indices all look different. The U.S. index has a large weight in information technology (28% as of 12/31/2020) while the EM and EAFE indices are both heavy in financials and materials (Figure 1).[6] Individual countries can also have their own return drivers, such as policy decisions that impact businesses, concentration and expertise in a given sector, or a new technology. While the globalization of the world means markets can be closely correlated at times, it is unlikely for all 21 EAFE countries and 27 Emerging Market countries to be moving in lockstep. Having broad exposure opens the door to wide-ranging return drivers that may help smooth out an investor's experience.

The Non-U.S. Opportunity Set

There is no denying that the U.S. has been dominant for quite some time and is the largest country by GDP and market capitalization in the world. Using the MSCI ACWI Index as a proxy for global market caps, the U.S. has a current weight of 57%

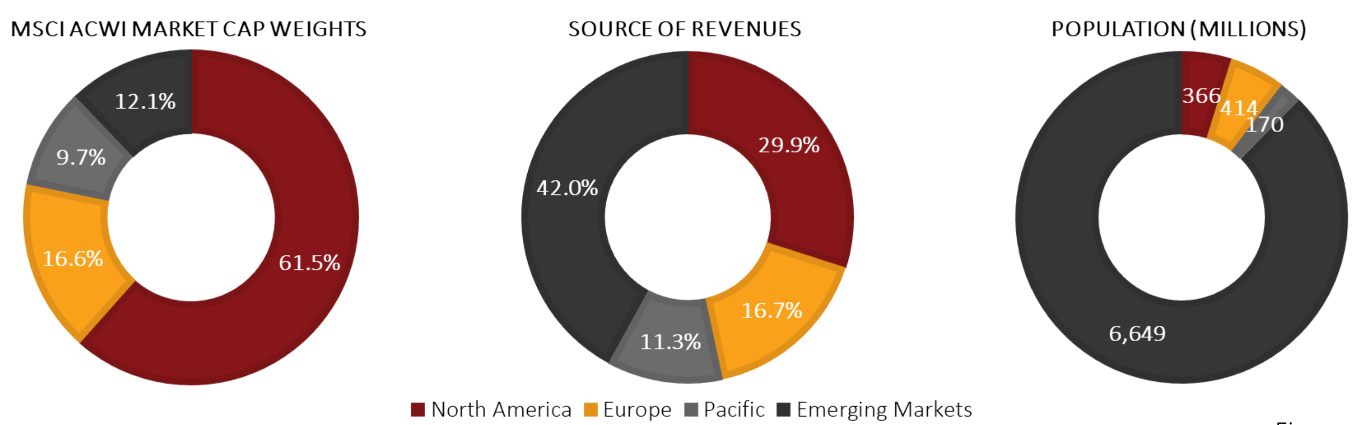


Figure 2

[6] Morningstar Direct

(Figure 2).[7] While that is impressive in its own right, 43% of world's market capitalization is still available for investment. International markets are widely considered to be less efficient than domestic markets, meaning they are ripe for investment opportunities with the right institutional approach. That may be even truer once smaller capitalization companies are considered. Also worth considering is to what extent the international markets are fragmented. Using the most basic example, the sheer number of countries in the MSCI EAFE and MSCI EM indices makes the universe more difficult to cover from an investment research point of view, opening the potential for more frequent mispricings.

Market Mismatch

Investment opportunities also appear attractive when you compare the world's market capitalization to other statistics. For example, despite making up 60% of the world's market cap, only 30% of global revenue comes from North America. Meanwhile, Emerging Markets make up 12% of the world's market cap and nearly 40% of global revenues.[8] Even more out of line with market capitalization is population. This can be attributed partially to higher income levels in the U.S. versus elsewhere, and the differences are stark. Europe has a larger population than the U.S. but approximately a quarter of the world's market capitalization. Meanwhile, Emerging Market economies account for most of the world's population, but their lower overall wealth is reflected in their representative share of the world's market cap. This helps to establish the argument that the evolving demographics of the world will have a direct impact on the markets. Going forward, the expectations of a growing middle class, higher labor force participation among women, longer life expectancies, and other factors will be tailwind. These factors may be partially offset by lower birth rates and thus, aging populations in some areas; however, each region/country is different. Having the flexibility to invest in areas where the demographics are different than in the U.S. is another portfolio diversifier.

Valuations

A part of the recent U.S. dominance has been the strength of the dollar versus other currencies. A strong dollar means U.S. goods and services are more expensive for other countries. This impacts not only multi-national companies but also some governments and non-U.S. companies who use the dollar because of its reliability. From the U.S. perspective, a strong dollar is beneficial to our GDP growth as the U.S. is a net importer of goods, and has been for decades, but unfavorable for any non-U.S. investments that must be priced back to dollars. As seen in Figure 3, the dollar has shown strength since the middle of 2014 and a reversal of the current trend will be a headwind for U.S. investors.[9] It is important to build an investment portfolio for all market cycles, and having a non-U.S. allocation will be helpful if and when the dollar's current strength falters.

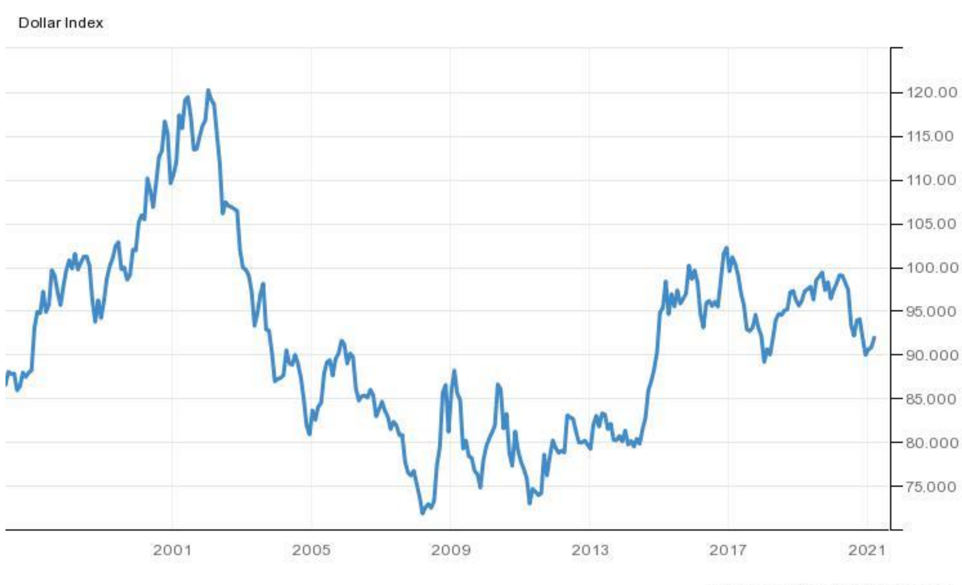
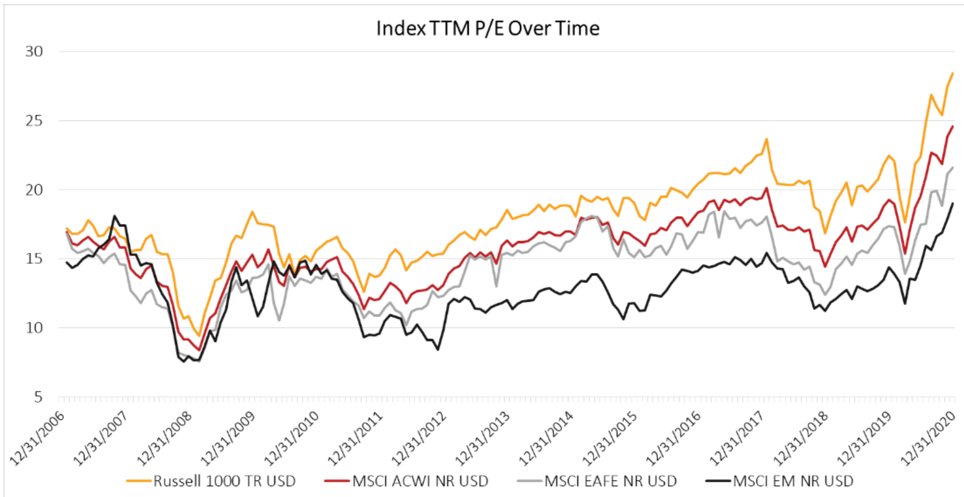


Figure 3

[7] Ladure, J. (n.d.). Global Investing Trends: Looking Beyond North America. Retrieved April 01, 2021, https://www.msci.com/research/global-investing-trends/beyond-north-america
[8] Ladure, J. (n.d.). Global Investing Trends: Tapping into Global and Regional Revenues. Retrieved April 01, 2021, https://www.msci.com/research/global-investing-trends/global-and-regional-revenues
[9] Trading Economics

Figure 4



For many institutional investors, the price you pay is important because upside potential is needed for an attractive return, no matter what metric an investor uses. It is important for investors to know that non-U.S. markets have historically traded at a discount to domestic markets (price to earnings shown in Figure 4).[10] At least a portion of the valuation differences can be attributed to the sector compositions that were outlined earlier; non-U.S. indices have typically had a higher allocation to historically cheaper sectors such as financials and materials. Additionally, some of the unique risks that exist when investing outside of the U.S. are likely priced in to the markets.

Some of this dispersion among valuations is warranted, but this again speaks to the opportunity set outside of the U.S. and how, with an institutional approach, there may be compelling investment opportunities to be had at prices that are tough to come by in the United States.

Conclusion

The breadth of market opportunity available beyond the domestic marketplace, and the various levels of diversification that come with it, can provide a strong framework for a strategic allocation to non-U.S. markets. We challenge investment committees to be aware of their behavioral biases and look past them for the benefit of their investment portfolio in the long run. No matter what stage of the process you are in, DeMarche is here to help you confidently navigate the global markets.

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[10] Morningstar Direct