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International Asset Allocation Revisited

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Investments in the U.S. stock market have in recent years had a stronger return than investments in international stock markets. For the three years 2014, 2015, and 2016, the average annualized return of the S&P 500 index was 8.87% whereas the average annualized U.S. dollar return of the MSCI ACWI ex US[1] was -1.78%. As Marshall Blume pointed out in his cover letter of September 2016, this has led to questions about the benefits of international exposure in the portfolio of a U.S. investor. Marshall noted that while there will be periods when international markets underperform, international stocks do deliver significant benefits from diversification. Combining this benefit with the view that future returns are unpredictable does justify international exposure. The amount of international allocation should be determined as part of the risk control process.

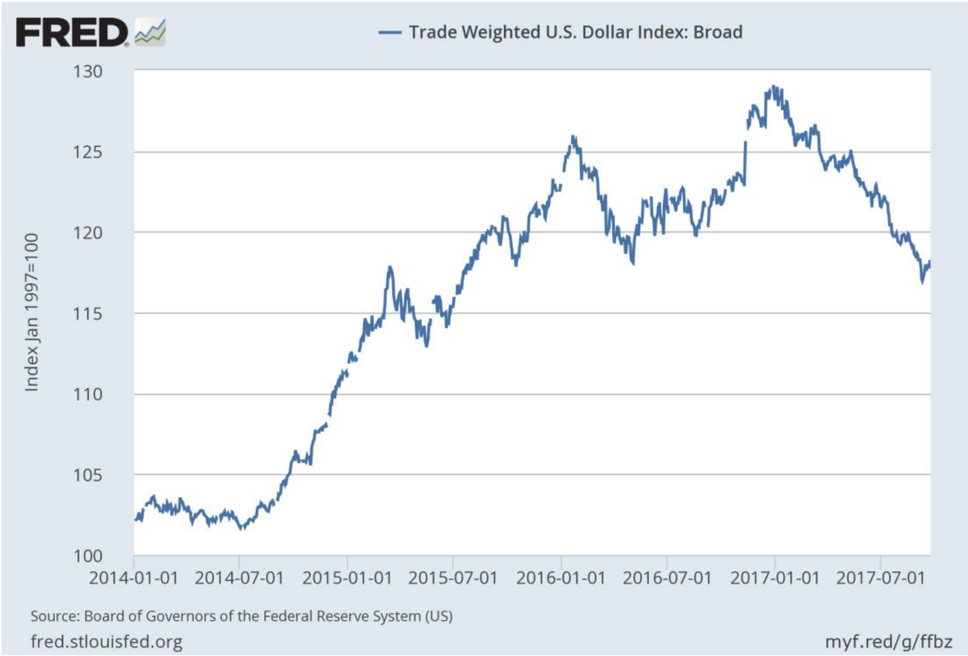
Now that the first three quarters of 2017 have passed, we can consider how the domestic versus international allocation decision has influenced performance this year. While nine months of history in the stock market is too short a period to base investment decisions on, it is interesting to look at the role international allocation. This role is the issue considered in this edition of Partner Talk.

[1] The MSCI ACWI ex USA Index captures large- and mid- cap representation across 22 of 23 Developed Markets countries (excluding the US) and 23 Emerging Markets countries. The index covers approximately 85% of the global equity opportunity set outside the US. The return reported includes a reduction related to local withholding taxes on dividends.

International markets have bounced back with a strong performance year-to-date. For the first three quarters, the MSCI ACWI ex U.S. has generated a U.S. dollar return of 21.13%. In contrast, using the S&P 500 Index as a measure of the U.S. market return, the U.S. market is up 14.24%. While the U.S. return is itself solid, an international allocation would significantly boost portfolio performance. We next address possible explanations of this international strength.

At a fundamental level, economic growth across the globe is a key driver of stock market performance. Investors' views about economic growth have changed as the year has moved forward. For 2017, the U.S. did have a strong second quarter with GDP increasing at an annual rate of 3.1%. However, the consensus growth forecast for 2017 remains at about 2% - close to the forecast at the start of the year. In comparison, the forecast for economic growth in 2017 for the European Union was 1.6% at the start of the year and has been increased to about 2.3%. While the projected growth rates in the U.S. and Europe do not differ dramatically, this increase in optimism with respect to European economic growth (and international growth broadly) relative to the U.S. is a driver of recent higher international returns.

Another approach to think about the return differences across countries is to recognize that differences in economic growth will eventually show up in the strength of the U.S. dollar. In a U.S. investor's portfolio, with international returns expressed in dollar terms, a strong dollar will dampen international returns and a weak dollar will strengthen international returns. One measure of the strength of the U.S. dollar is the Trade Weighted U.S. Dollar Index (broad version) published by the Federal Reserve Bank. The index is a measure of the value of the United States dollar relative to other world currencies. The chart below shows the value of this index from January 2014 through September 2017.



This graph illustrates striking results over the past four years. The dollar index shows that the dollar had an episode of significant strength for the three years ending with 2016 and has had weak performance in 2017. For the three years ending in December 2016, the dollar appreciated on average 7.95% annually, contributing to the 2014 to 2016 weakness of international markets previously cited. In contrast, the graph shows the dollar has been declining this year, falling by 8.3% through the end of September, corresponding to the strong international market performance noted previously. One can conclude that in a strong dollar environment, international stocks will usually underperform and in an economic environment where the U.S. dollar weakens, strong international performance is likely. The performance of PMA portfolios has benefited from the international exposure this year.

An implication of this consideration of the role of the strength of the U.S. dollar is that an accurate forecast of the path of the dollar would be very useful for international asset allocation decisions. However, evidence supporting the predictability of the future value of the U.S. dollar does not exist. The model with the most empirical support for the behavior of the U.S. dollar is the "random walk" hypothesis. If exchange rates follow a random walk, future changes in the value of a currency are not forecastable and periods of strong or weak dollar performance are not predictable.

So, why maintain international exposure? We can circle back to the points Marshall Blume made last year. The lack of predictability of future exchange rate movements argues against using international funds as a means of generating higher returns. Despite this lack of predictability, there are diversification benefits from international exposure. This diversification benefit of international exposure can play a useful role from a risk control perspective. Further, this lower risk does not require a significant sacrifice on the return dimension. One should expect periods where international exposure will boost returns and other periods where the exposure will reduce returns. However, overall the impact of a modest international allocation will be to improve the risk-adjusted performance. This strong risk-adjusted performance is a key goal of PMA's investment process.