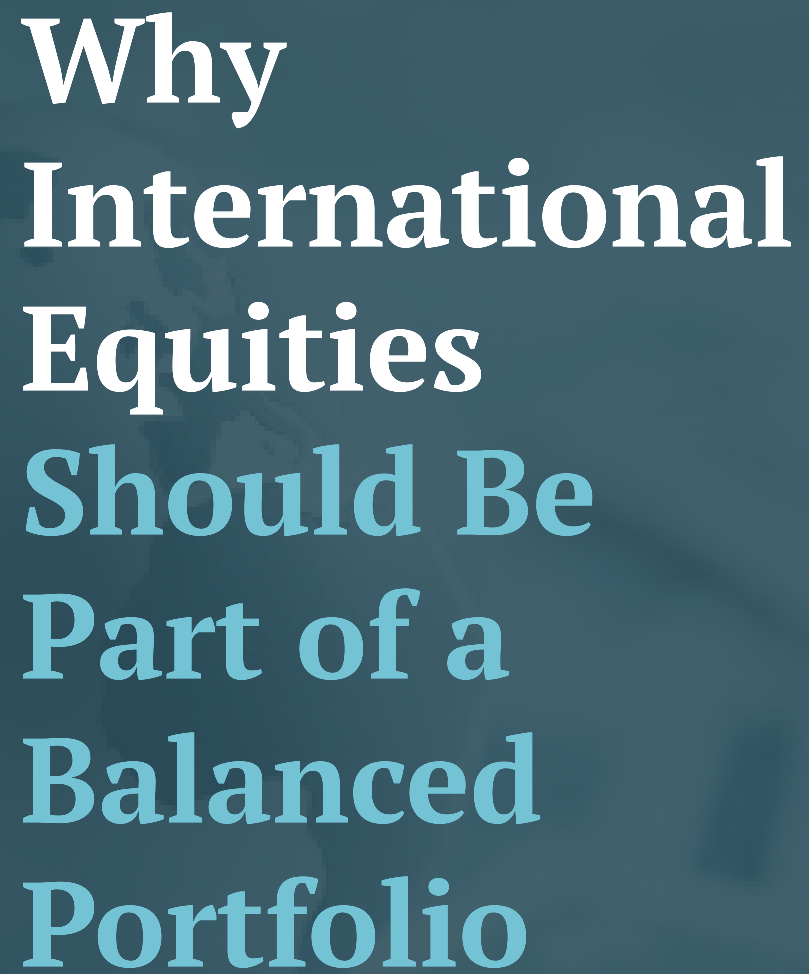


Why International Equities Should Be Part of a Balanced Portfolio

An Assessment of the Overall Risk/Return for Your Portfolio

JOHNSON FINANCIAL GROUP®

If you have been an investor in International Equities over the past decade, you are probably asking the same question I am asked constantly by my children: "Why?"

The past decade has proven difficult for International Equities, which have meaningfully underperformed their Domestic counterparts. The table below shows the trailing 10-year performance of the Russell 3000 Index and MSCI All Country World ex-USA Index—broad-based indices that are representative of domestic and international markets, respectively. Both markets have generated attractive absolute returns over the trailing 10-years. However, the Russell 3000 Index has produced a return nearly 2.5x that of the MSCI All Country World ex-USA Index.

Index	10-Year
Russell 3000	16.20%
MSCI ACWI ex USA	6.57%

Source: Morningstar Direct. Returns as of 8/31/2021

With such a pronounced performance differential, many people are ready to throw in the towel on International Equities. In this paper, I'll attempt to answer the following questions:

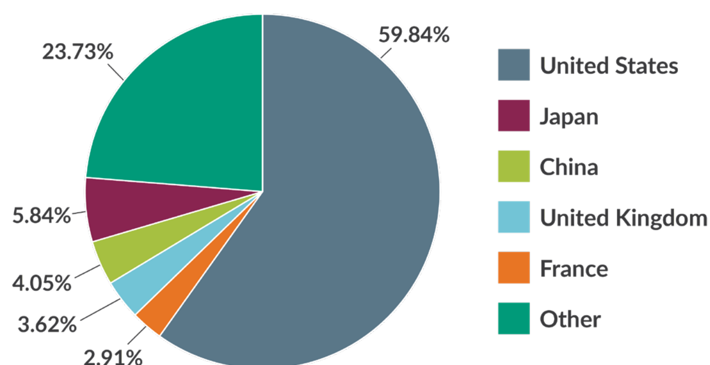
1. Why should International Equities be part of a balanced portfolio?
2. And will the next decade prove more fruitful for International Equities than the past decade?

Portfolio fit

Let's begin with why International Equities should be part of a balanced portfolio.

Opportunity set. What you see in the following chart is the country weights for the MSCI All Country World Index, which is a good proxy for the global equity investable opportunity set. It includes both Developed Markets and Emerging Markets as part of the composition.

COUNTRY WEIGHTS



Source: MSCI.com

You can see that while the U.S. constitutes roughly 60% of the index or market cap, there is a large opportunity set (40%) outside of the U.S. By not including International Equities in a portfolio, you are forgoing the possibility of investing in a number of great companies: Taiwan Semiconductor, Alibaba, Nestle, Samsung, Novartis, LVMH, Toyota, etc. Limiting the opportunity set limits the potential for generating alpha in a portfolio.

Diversification. A core tenet of our industry is don't put all your eggs in one basket. If you have been invested only in the FAAMG stocks (Facebook, Amazon, Apple, Microsoft, Google) over the past decade, you probably feel really good…in fact, you probably feel like a genius. However the market has proven very adept at humbling investors who exhibit too much hubris. A narrow focus may work out for a while, but it's very difficult to be right all the time.

> A core tenet of our industry is don't put all your eggs in one basket.

MSCI EAFE NR USD

TIME PERIOD: 1/1/1990 TO 8/31/2020

Source: Morningstar Direct Rolling Window: 3 years 1 month shift Calculation benchmark: S&P 500 TR USD 1936

So incorporating different asset classes that act or perform differently helps improve the overall risk/return of a portfolio. The chart above shows the correlation of MSCI EAFE to the S&P 500 Index. Anything less than 100 provides some level of diversification benefits.

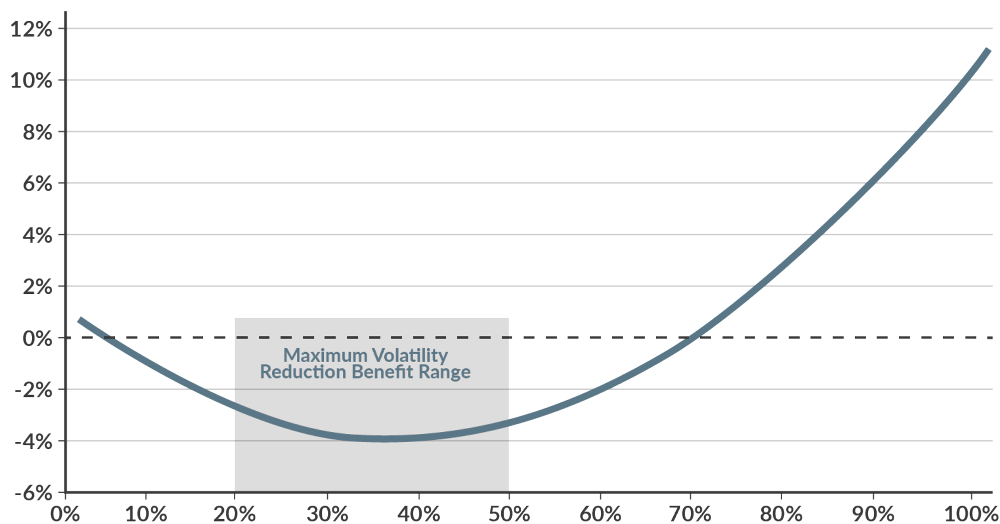
The correlation of International Equities has averaged 75% over the last decade. Now admittedly, the correlation has increased since the 1990s, thus dampening some of the diversification benefits. However, incorporating International Equities does improve the overall risk/return of the portfolio.

Here at Johnson Financial Group, we evaluate the diversification benefits of incorporating numerous asset classes as part of our asset allocation process when constructing portfolios. In essence, what combination of asset classes provides the best risk/return expectations for a client's risk profile.

This same exercise is undertaken by companies across the financial industry. For example, the next chart below is from a research paper conducted by Vanguard, in which the firm analyzed what allocation to International Equities resulted in the maximum volatility reduction to a portfolio. As you can see, an allocation between 20%-50% provided the greatest reduction in portfolio volatility. Within the equity sleeve of Johnson Financial Group portfolios, International Equities represent a 30% allocation.

PERCENTAGE OF EQUITY ALLOCATION TO NON-US STOCKS

CHANGE IN PORTOLFIO VOLATILITY



Source: Derived from data provided by Vanguard and MSCI as of March 31, 2020
Notes: Non-U.S. equities represented by MSCI World index ex USA and U.S. stocks are represented by the MSCI USA Index from March 31, 1970 through March 31, 2020. ***Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.***

The next decade

Now let's shift to why the next decade may prove more fruitful for International Equities.

Recency bias and cycles. When investors question the benefits of investing in International Equities, recency bias is likely a significant factor. Recency bias is the tendency to place too much emphasis on recent events, expecting those events will continue into the future.

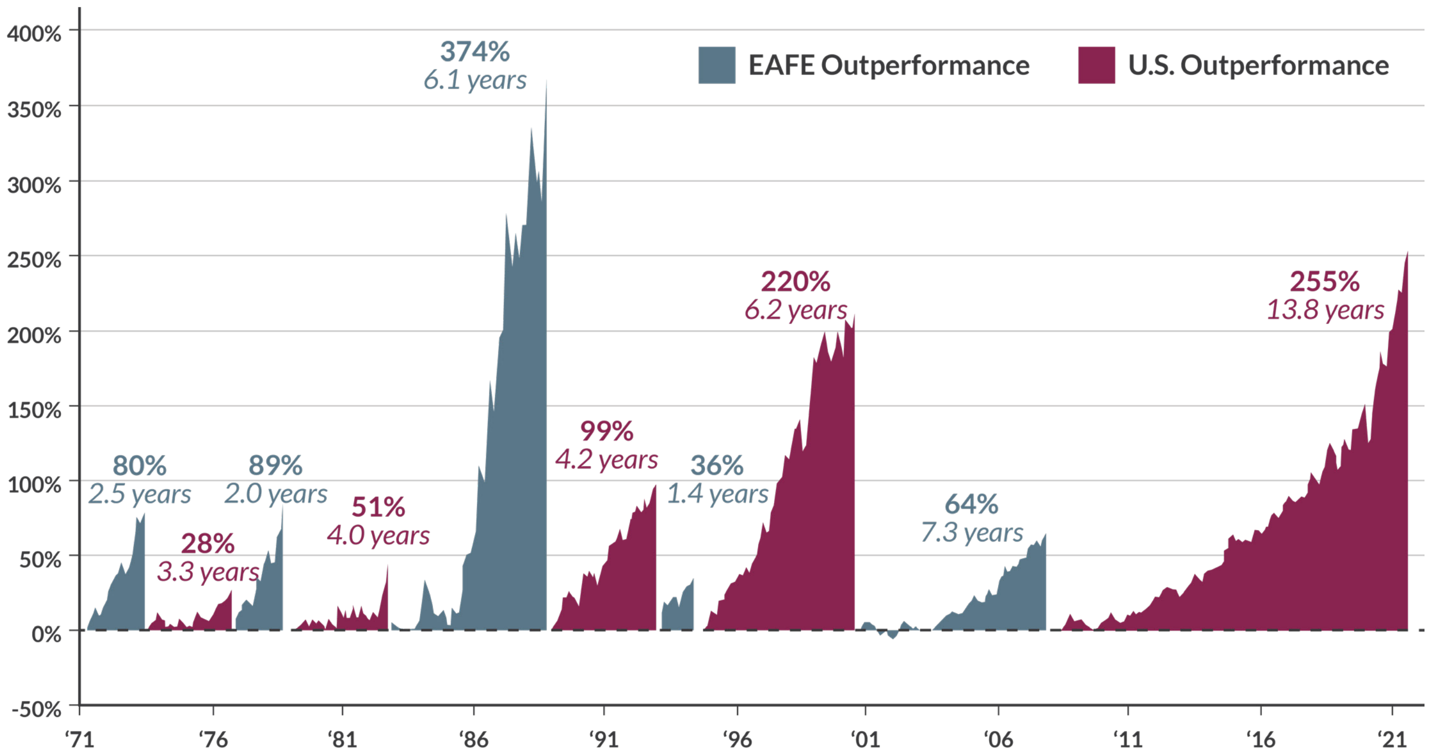
In this case, investors look at the outsized returns of Domestic Equities and expect these will continue into perpetuity. However, history provides numerous examples of the fallacy of this thinking. Markets move in cycles; the asset class that was in favor for the past year(s) becomes persona non grata as investors shift their attention elsewhere. The chart below provides a clear example, highlighting periods of Domestic and International Equity outperformance going back to 1971.

The blue represents periods when International Equities outperformed and the burgundy when Domestic Equities outperformed. The two figures accompanying each period shows, first, the level of outperformance during the cycle and, second, the duration of the outperformance.

When you focus on the right-hand side, the recent dominance by Domestic Equities is clear. This has been the longest (nearly 14 years) and most pronounced (over 250%) period of Domestic Equity outperformance in 50 years. Will this continue? It could. But given the length and level of outperformance by Domestic Equities, this cycle is long in the tooth.

MSCI EAFE AND MSCI USA REALATIVE PERFORMANCE

U.S. DOLLAR, TOTAL RETURN, CUMULATIVE OUTPERFORMANCE*



Note: Regime change determined when there is sustained outperformance of one region over the other for cumulative 12 months.

**Cycles of outperformance include a qualitative component to determine turning points in leadership. Guide to the Markets – U.S. Data are as of August 31, 2021*

Source: FactSet, MSCI, J.P. Morgan Asset Management

> Markets move in cycles; the asset class that was in favor for the past year(s) becomes persona non grata as investors shift their attention elsewhere.

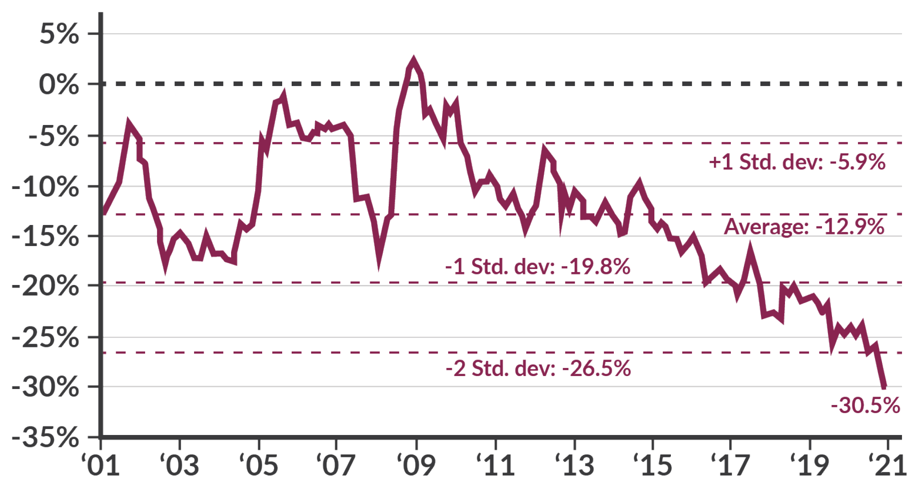
Valuations. The next reason why the next decade could be better for International Equities is valuation. The price you pay for a security has a direct impact on expected returns. Most markets—both stocks and bonds, Domestic and International—are trading at high valuations. However, on a relative basis, International Equities are trading at a significant discount relative to Domestic Equities.

Below, the upper chart shows that on a forward 12-month basis, the P/E ratio of International Equities is trading at a discount more than two standard deviations below the average. So International Equities are trading at a level that only happens 2.5% of the time. If there is any reversion to the mean, this would be a tailwind for International Equities. Income/yield metrics also favor International Equities.

The lower chart shows the difference in dividend yields between International Equities and Domestic Equities. Currenty, the dividend yield for International Equities is 1.5% more than Domestic Equities. So if the S&P 500 has a dividend yield of 1.5%, the MSCI ACWI ex-US has a dividend yield of 3.0%. Historically, dividends have represented a significant portion of an investment's total return, approximately 40%. The elevated dividend yield gives International Equities a meaningful leg-up.

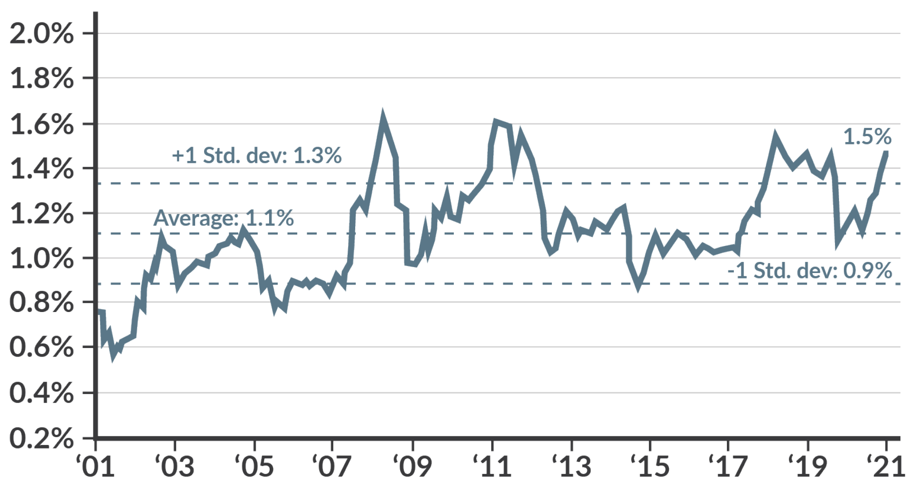
PRICE-TO-EARNINGS DISCOUNT VS U.S.

MSCI AC WORLD EX-U.S. VS S&P 500 INDICES, NEXT 12 MONTHS



DIFFERENCE IN DIVIDEND YIELDS VS U.S.

MSCI AC WORLD EX-U.S. MINUS S&P 500 INDICES, NEXT 12 MONTHS



Source: Factset, MSCI, Standard & Poor's, J.P. Morgan Asset Management as of 8/31/2021

Expectations. Lastly, let's focus on future expectations. This is somewhat akin to looking into a crystal ball, but using long-term capital market assumptions (LTCMA) is a bedrock of asset allocation. It feeds into decisions Johnson Financial Group makes at the portfolio level and also from a financial planning perspective. Firms use valuation, earnings growth and qualitative assessments to determine their long-term capital market assumptions for asset classes.

Below, I've pulled together two different LTCMA from well-known providers: Vanguard and JPMorgan. Both firms are projecting what they believe the returns of different asset classes will be over the next decade.

In red, I've highlighted Domestic Equity markets (typically Large Cap). The projected returns are in the range of 2.3%-4.3%. Now, compare that to International Equities, highlighted in green. Each firm is assuming International Equities will perform better, in the range of 5.1%- 7.1%...nearly three percentage points better. And this view point is by no means limited to these two firms. International Equity outperformance appears to be a consensus view among most investment management firms.

VANGUARD (10-YEAR)

Equities	Return Projection	Median Volatility
U.S. Equities	2.3% - 4.3%	16.7%
U.S. Value	2.9% - 4.9%	18.9%
U.S. Growth	-0.6% - 1.4%	17.7%
U.S. Large-Cap	2.2% - 4.2%	16.3%
U.S. Small-Cap	2.1% - 4.1%	21.8%
U.S. Real Estate Investment Trusts	2.2% - 4.2%	19.3%
Global Equities ex-U.S. (unhedged)	5.1% - 7.1%	18.7%

Source: Vanguard

JP MORGAN (10-YEAR)

	Compound Return 2021 (%)	Arithmetic Return 2021 (%)	Annualized Volatility (%)	Compound Return 2020 (%)
U.S. Large-Cap	4.30	5.13	14.80	5.60
U.S. Mid-Cap	4.40	5.73	16.93	5.90
U.S. Small-Cap	4.60	6.33	19.44	6.50
Euro Area Large-Cap	6.60	8.65	21.42	7.70
Japanese Equity	6.50	7.50	14.76	7.20
Hong Kong Equity	7.60	9.44	20.30	6.30
UK Large-Cap	7.50	8.83	17.20	7.60
EAFE Equity	6.50	7.80	16.92	7.20

Source: J.P Morgan

Closing thought

I am convinced I'll never have an adequate answer to the question "Why" when asked by my children. Fortunately, I find these investment related questions easier to answer than those posed by my children. If you're among those asking "Why International Equities," the takeaways here are that they contribute to a balanced portfolio and the next decade looks promising.

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