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WHAT IS THE ROLE OF INTERNATIONAL EQUITIES IN A DIVERSIFIED PORTFOLIO?

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If you have recently evaluated the performance of the different components of your portfolio, you are probably wondering why you maintain positions in international equities. International equities, both developed and emerging, have lagged U.S. equities since the end of the Financial Crisis, prompting many questions from U.S.-based investors. In addition to the impact on portfolio returns, many investors wonder what truly represents global exposure, what role currency plays and whether or not they should hedge their currency exposure. Despite their recent underperformance relative to U.S. equities, we have found that international equities offer numerous benefits: They play an important role in reducing U.S. investors' "home bias", they improve portfolio diversification and risk-adjusted returns (i.e. higher returns and lower risk over the long term), and they offer increased exposure to higher-growth economies

Leadership cycles. As is the case with most financial markets, leadership ebbs and flows over time. This is especially true with regard to the relationship between international and domestic equities, which have taken turns outperforming since 1971. The current cycle has favored domestic equities, with the S&P 500 outperforming the MSCI EAFE from November 30, 2007 to December 31, 2015. The current leadership cycle for U.S. equities started after a period when international equities lead, when from August, 2000 through November, 2007 international equities outpaced domestic equities by 54%. Interestingly, despite the magnitude of the current U.S. equities outperformance, only three times in the past 10 years (through 2014) have domestic equities been the world's top performing market. Regardless, the current leadership rally for U.S. equites has them far above their pre-crisis highs while developed, international and emerging market equities are still significantly below their peak levels.

Valuations. The recent outperformance of domestic equities has also had an impact on valuations, with both international equities (developed and emerging) currently offering less expensive valuations than U.S. equities. For example S&P 500 valuations have been cheaper than current levels 83% of the time since 1969 (as of 12/31/2015). This contrasts with the historically inexpensive valuations within developed, international countries, for example, MSCI EAFE valuations have been cheaper than current levels 51% of the time since 1969. There have been many drivers of the re-rating or increase in valuation of U.S. equities, such the perceived safety of U.S. equities and the accommodative policy we have experienced from our Central Bank. It is important to note that monetary policy will likely no longer be a tailwind for U.S. equities, with the Federal Reserve having just entered a tightening policy phase. The tighter monetary policy in the United States is in sharp contrast to Europe, Japan and China, where Central Banks have recently implemented or expanded monetary easing. While accommodative policy is not the sole driver of valuations, it has played an important role in reducing the volatility of risk assets.

International exposure. Given the expansion of globalization, borders between countries have truly become blurred from an economic perspective, leading many to wonder, what constitutes international exposure? The globalization trend is well illustrated by S&P 500 revenue, of which 48% is sourced from outside the U.S. (as of 12/31/2014). It is important to note that the revenue exposure from international companies does not provide the same benefits to a portfolio as owning companies domiciled internationally. As referenced above, international equities have lagged over the past several years, in part due to monetary policy which has not stimulated economic expansion overseas, and ultimately has held many internationally domiciled companies back. This is also illustrated by the current positioning within the business cycle of the United States, Europe and Asia, where the U.S. economic recovery has clearly outpaced its global peers.

Non-dollar exposure. Introducing non-dollar exposure naturally raises the question of currency hedging, or converting non-dollar exposure back to U.S. dollars. Ultimately, owning non-dollar exposure adds an additional source of volatility and return to a portfolio, and the decision of whether or not to hedge back to U.S. dollars is dependent on an investor's time horizon and risk tolerance. To put the currency impact in context, during 2014 the MSCI EAFE returned 6.4% in local currency terms while it declined -4.5%

in U.S. Dollars, and in 2015 the returns were +5.8% and -0.4% respectively. It is important to understand the ramifications that currency exposure can have in different market cycles and to actively determine whether to accept the local currency exposure or hedge back to U.S. dollars on a currency by currency basis. If currency hedging is utilized, it should done in a prudent manner, also on a currency by currency basis, and not as a blanket.

Home-bias. Numerous studies have found that investors exhibit strong 'home bias', or the tendency to overweight their exposure to domestic equities, relative to their country's global market capitalization. This bias is particularly impactful for U.S.-based investors, given that U.S. equities represent over 50% of global equity market capitalization (MSCI ACWI, 12/31/2015). By making active bets and overweighting U.S. equities, U.S.-based investors may be missing out on the potential diversification benefits of international equities. One may ask why not just own multinational companies that are based in the U.S.? There are several reasons why this would not impact a portfolio in the same way as owning internationally domiciled companies, for example losing diversification benefits amongst sectors as there are varying sector concentrations between the U.S. and abroad. Your portfolio would also miss out on participating in innovating, leading companies that happen to be domiciled outside of the U.S.

As mentioned earlier, owning internationally domiciled companies over the long-term often results in reduced volatility at a portfolio level. This reduction in volatility is yielded by the changing correlations between U.S. equities and international equities, as over time there will be numerous instances when they will be moving in different directions. Practically speaking, investors can benefit from the natural ebb-and-flow of asset class performance by including international equities in their portfolio. Global equity correlations (the extent to which things move together), recently stood at 0.47% on a one year basis, illustrating the benefits of holding a diversified portfolio.

As was the case for most of the 2000's, economists are forecasting higher levels of growth for emerging market countries relative to their developed counterparts. In addition to gaining exposure to potentially higher economic growth, investors in international equities benefit from an extra layer of diversification yielded by asynchronous monetary policy and market cycles. While during recent years international equities have underperformed, they remain a critical part of long-term asset allocation and portfolio management.

Ben leads the strategy and implementation of the Waldron Investment Team, overseeing asset allocation, developing investment strategies for Waldron clients aligned with their unique goals and driving due diligence for investment managers.

Bill is focused on performing investment manager due diligence, implementing goals-based asset allocation strategies and working with Wealth Counselors to integrate investment management within each client's customized financial plan.