The Compelling Case for International

By:

Christopher Browne, CFA ®

Chief Investment Officer, Democracy Investments

Issue Date: September 21, 2023

Democracy Investments Index Provider
1480 Moraga Road Suite C #378 Moraga, CA 94556
Web: www.democracyinvestments.com
Email: info@democracyinvestments.com

The information contained herein is current as of the Issue Date and is subject to change without notice.

Executive Summary

- International stocks currently trade at a significant discount to the US
- Over longer-term horizons, international stocks provide diversification benefits that dampen the volatility of an equity portfolio
- The world is splitting into two distinct spheres – those who wish to align with the US and those who wish to align with BRICS
- Businesses under authoritarian regimes are exposed to more risk than those in democratic nations

The Compelling Case for International

As investors have enjoyed strong returns in the US market, both for this year and since the Global Financial Crisis, it could be time to evaluate portfolio moves going forward.

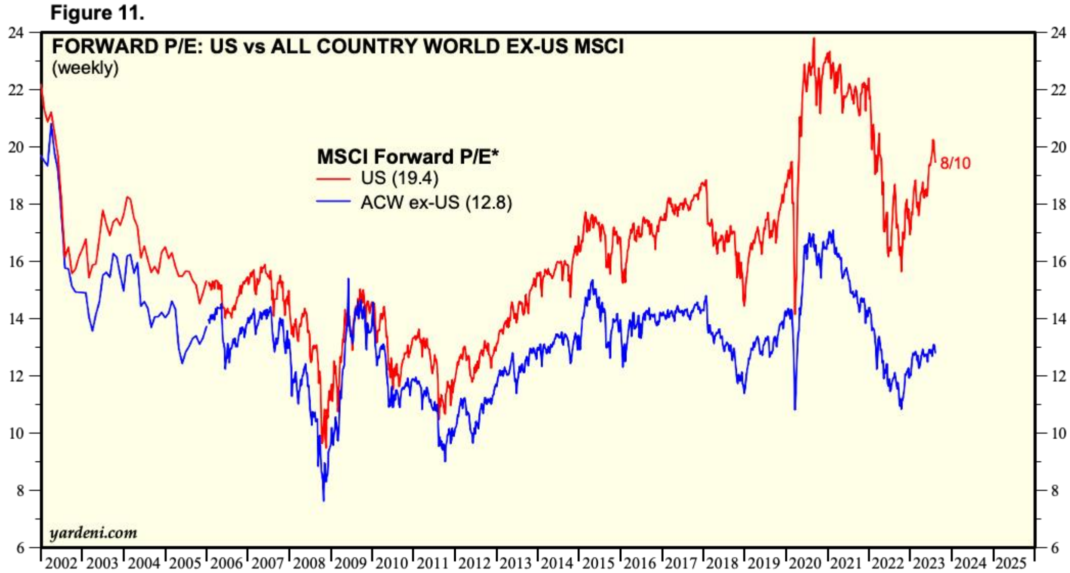
With regards to this year's market performance, S&P 500 performance has been largely dominated by about 7 or 8 individual names and is up about 18%. On an equal weighted basis, the picture changes dramatically with the equal weighted index up about 6%.

Given the higher multiples for US stocks, now might be the time to look at allocating to international equities.

Valuation

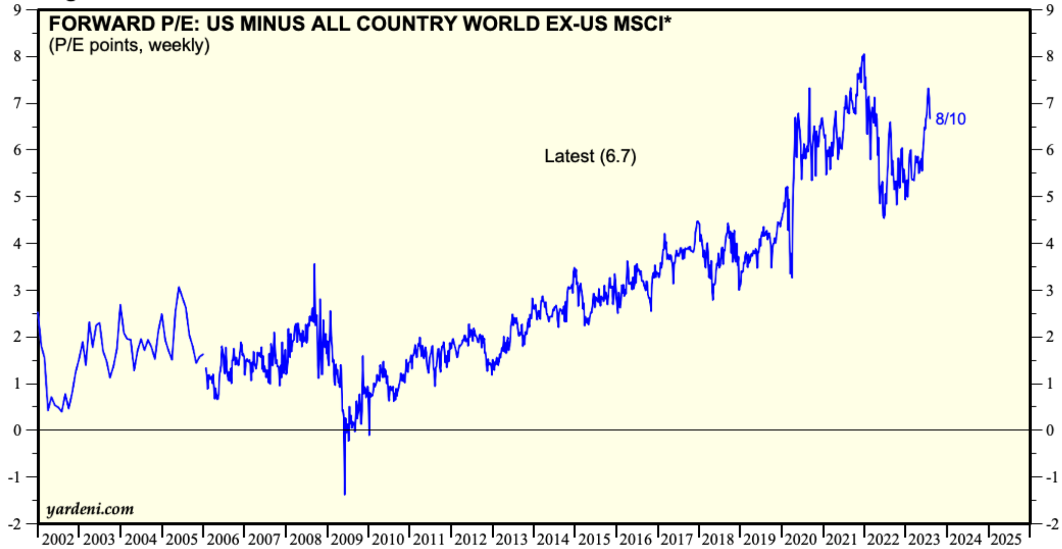
These two graphs from Yardeni Research show the 12-month forward P/E multiples for the US and international stocks. The United States currently trades at a 50% premium to international stocks on a forward earnings basis. This premium for US markets has existed since the Global Financial Crisis, and the bottom chart reflects that growth.

Figure 11.



* Price divided by 12-month forward consensus expected operating earnings per share. Monthly through December 2005, weekly thereafter.
Source: I/B/E/S data by Refinitiv and MSCI.

Figure 12.

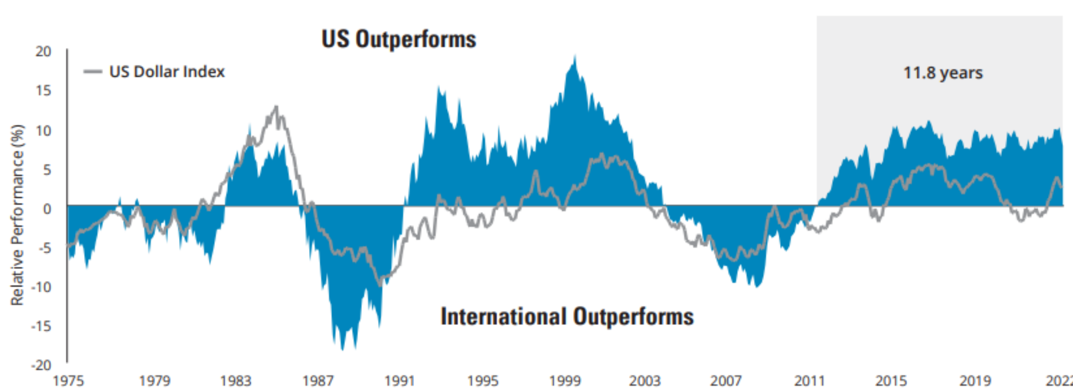


* Price divided by 12-month forward consensus expected operating earnings per share. Monthly through December 2005, weekly thereafter.
Source: I/B/E/S data by Refinitiv and MSCI.

Today we are at a point where the market is testing the highs in terms of spread between the US and international stocks. At the end of 2021, the spread was at its widest and international outperformed.

As depicted in the chart below, the relationship between US and international stock market performance tends to be cyclical but with unpredictable timing. As such, prudent investors would be wise to determine an appropriate long-term allocation to international stocks, especially as they currently appear to be undervalued, and rebalance diligently over time.

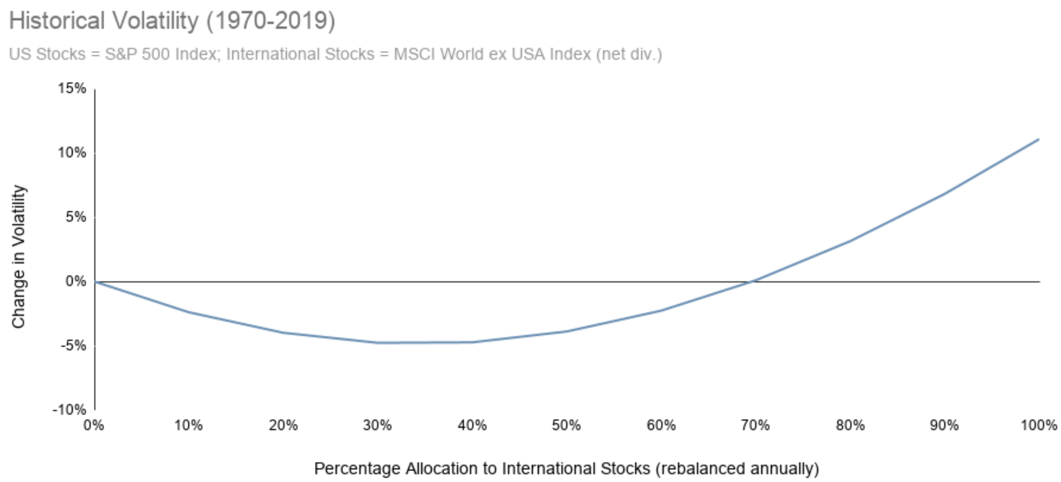
US Equity vs. International Equity 5-Year Monthly Rolling Returns (1/31/75-12/31/22)



The chart shows the values of the S&P 500 Index's returns minus the MSCI World ex USA Index's returns. When the line is above 0, domestic stocks outperformed international stocks. When the line is below 0, international stocks outperformed domestic stocks.
Data Sources: Morningstar, Bloomberg, and Hartford Funds, 12/22.

Diversification

A theme that has worked well for American investors since the Great Financial Crisis has been growth over value. Despite the propensity of cyclical value stocks to do well during prolonged economic expansions, the recent low-growth, low-productivity recovery has put a premium on companies with sustained high earnings growth. While favoring U.S. over international stocks, and growth over value stocks may appear to be separate decisions, they are, in fact, related. A look at the composition of the world's major market benchmarks shows that the S&P 500 is essentially a growth index, with much higher allocations to traditional growth sectors than the rest of the world.



How much of an allocation to international stocks is the right amount? Traditionally many investors have started with a default position of wanting to hold 100% US stocks but were willing to add international exposure if they believed it would reduce overall portfolio volatility and make for a smoother ride. As you can see in the chart above, adding international stocks to an otherwise US portfolio would have historically reduced the volatility up to the point of 70% international exposure.

The reason international stocks provide diversification benefits over the long run is that they offer exposure to a wider array of economic and market forces, producing returns that vary from the US market.

All World funds typically contain a 60% allocation to the United States, and 40% to the rest of the world (ROW or ex-US)). This would imply that for a portfolio that is 80% equities and 20% fixed income, the neutral weighting to ROW/ex-US is 32% of the total portfolio. For 60%/40% portfolios, the allocation is 24%. The simple table below shows the market neutral guidelines for allocations. Investor may want to tilt +/- 10% to these guidelines, depending on the relative attractiveness of the ROW/ex-US markets.

Equity	Fixed Income	ROW/Ex-US
100%	0%	40%
80%	**20%**	**32%**
60%	**40%**	**24%**
50%	50%	20%
40%	60%	16%

The Importance of a Democracy Tilt

The US-led western order and the Chinese/Russian-led BRICS are in the process of a long and painful economic rivalry. For one, China and Russia have been spearheading an effort to develop a new currency alternative to the US dollar. Additionally, the BRICS have recently agreed to admit six new members: Saudi Arabia, Iran, Egypt, Ethiopia, Argentina, and the United Arab Emirates. Despite the efforts of BRICS to expand their economic power, many western companies since the COVID outbreak have been re-evaluating their supply chains and have begun moving resources to countries they deem more reliable. Janet Yellen, the current Secretary of the Treasury, calls this process “friend-shoring.”

A main reason these companies are moving their resources to reliable countries is because of severe economic issues in China and Russia. China is dealing with a housing crisis, including a recent declaration of bankruptcy by Evergrande, the second largest property developer in China. China also has a debt overhang from local government financing vehicles and a shrinking labor force predicted to keep declining until the end of the century. This shrinking labor force, along with minimal productivity increases and other structural and institutional constraints, contributes to China’s decreased growth potential. Another element of China’s population and labor force crisis is their rising youth unemployment rate, which was reported by the PRC as 21.3% in June 2023. They have decided to no longer release monthly figures on youth unemployment. Finally, global demand for imports is falling and China has suffered a 5% decrease in exports in the first seven months of 2023, which economists predict will only increase. Russia’s issue is their involvement in a war in Ukraine that is increasingly isolating them economically and politically.

While China and Russia are dealing with their respective economic issues, there are other general restrictions placed on businesses under authoritarian leaders. These restrictions emerge as regimes want to restrict the influence of the business community to consolidate a leader’s power. The restrictions on business communities are fewer, or at least more predictable, in democratic nations because of the functioning of government. Democratic nations need consensus within their legislature and de facto agreement by citizens in order to implement or revoke restrictions, not simply because of an autocratic whim. In addition to this more secure business environment fostered by democratic norms and traditions, democratic nations offer better human rights, more freedoms related to speech and press, and better environmental policies. The democracy tilt, at scale, provides an incentive for countries to take even small steps to improve their democracy score. The saying we like to use is – “Come for the alpha, stay for the weapon.”

This leads to our belief that companies in the Western democratic order will outperform those in more authoritarian states. The western order has been stable since its creation after WWII and won't be exposed to the same international and domestic risks as authoritarian countries will. As China, Russia, and the rest of BRICS diverge from the established western order, they will be forced to deal with economic and political issues without the help of many developed markets. Democratic nations therefore are more able to rely on each other economically and possess more stable economic institutions than their authoritarian counterparts.

Given all the above-mentioned factors, investors are encouraged to take an in depth look and evaluate the new compelling case for international in today's dynamic environment.