The Investment Argument for an International Equity Democracy-Tilted Portfolio

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Executive Summary

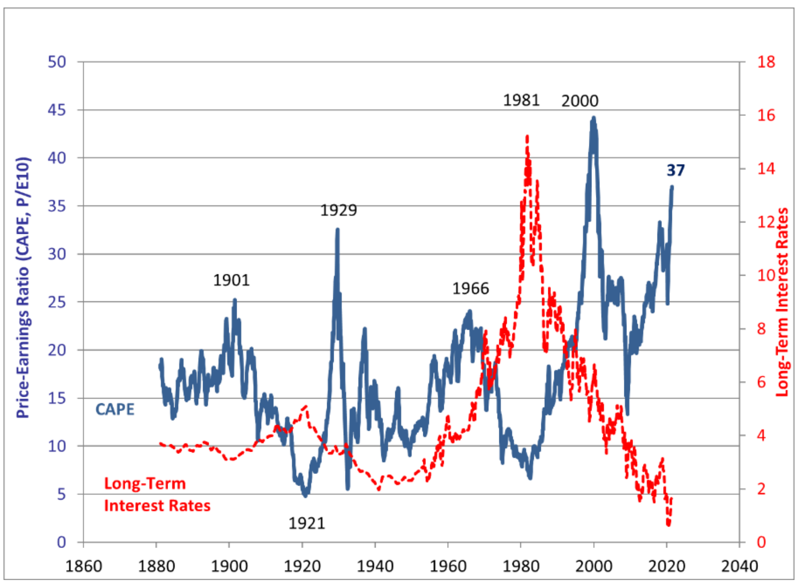
- International stocks appear cheap relative to the United States
- In order to get diversified exposure to a basket of international stocks, many investors use passive/systematic market capitalization weighted products (mutual funds, ETFs)
- However, these products typically do not account for the geo-political ramifications of investments in authoritarian regimes
- Using the Economist's Democracy Index to tilt market capitalization weighted portfolios away from authoritarian regimes and toward democracies has resulted in very similar return streams, while at the same time providing an incentive to countries to reform and to receive more investment

International Stocks are Cheaper

In the 1980's and 1990's, the argument for including international equities in one's portfolio largely stemmed from their expected diversifying effect on the portfolio due to their lower correlation to the US market. Over time, these correlations converged, and the expected diversification became much more muted. Combine that with lower growth, globalization, and the rise of US-based multi-national companies, to the result was disappointing returns and a shift away from international equities by US investors.

But it might be time to take a new look at international equities. This time, not necessarily for their diversification, but rather on a pure valuation basis.

The US market is pricy, based on current consensus earnings estimates. The chart below shows a long-term view of valuations based on the Case-Schiller Price/Earnings ratio (CAPE). CAPE employs a 10-year smoothing to earnings to compensate for earnings volatility. It is shown relative to long-term interest rates.



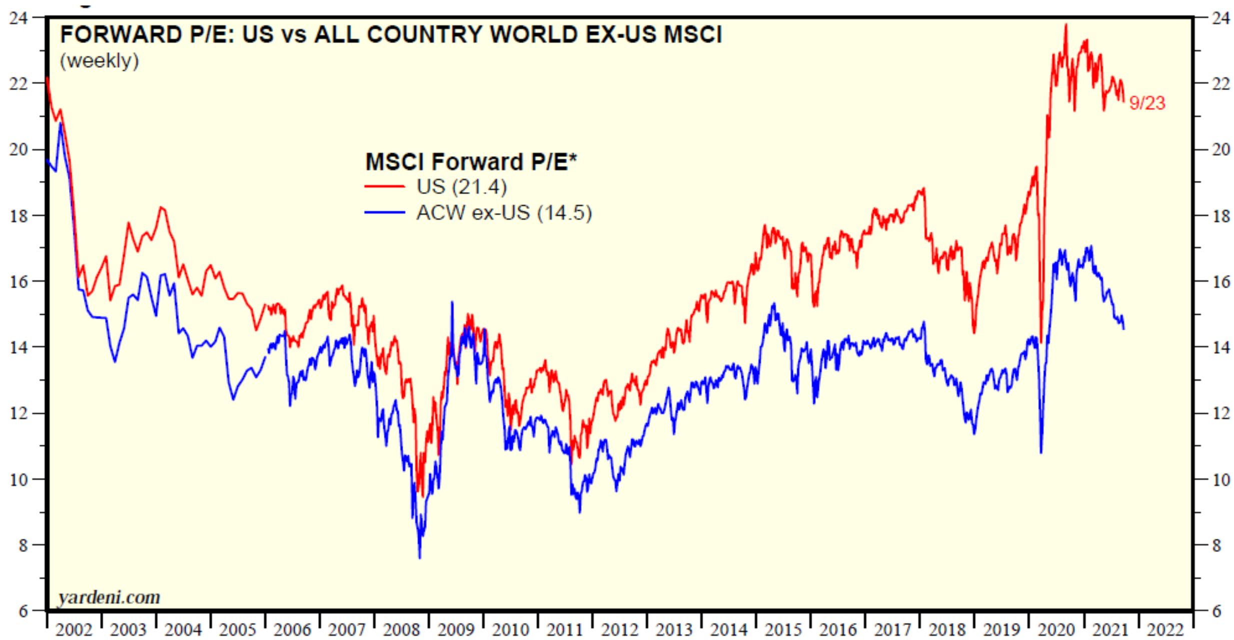
Case-Schiller CAPE vs. Long Term Interest Rates 1880-Current

Source: http://www.econ.yale.edu/~shiller/data.htm

With the exception of the Dot-Com spike, we are at relative peaks to previous highs for US markets. Some of this can be explained by the drop in long-term interest rates, but certainly not all of it. At a minimum, we can probably say the market is fully priced.

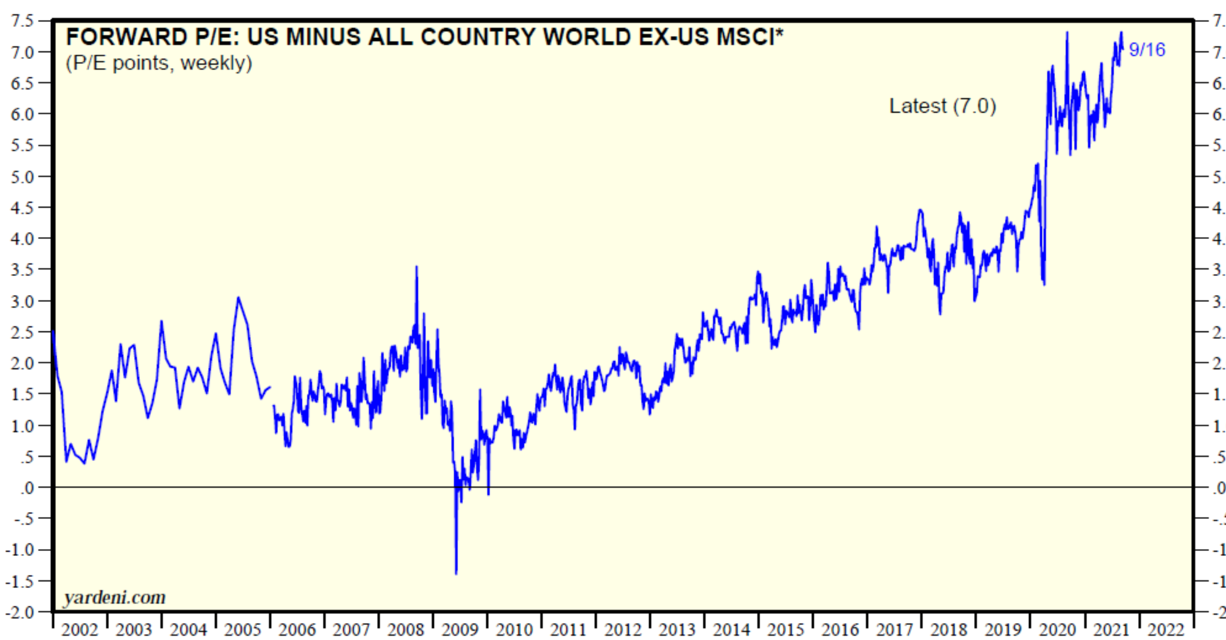
The move toward equities in general, and largely to US equities in particular, can be seen from the graphic below. It shows the MSCI World Dividend Yield as compared to the Barclay's Global Corporate Bond Yield. The spread between the two is the third line and tied to the right-hand y-axis. With global corporate bond yields dropping below global bond yields, investors are incentivized to take on equity risk. They are being compensated by approximately 50 basis points to assume this risk.

Next, we look at the difference between US equities and their international counterparts. The two graphs that follow are from Yardini Research. The first shows the 12-month forward P/E ratios for the US and the MSCI ACWI ex-US. Differing from the CAPE methodology, this graph takes consensus 12 forward earnings estimates divided by current price and represents a shorter time perspective of the last 20 years. The second graph shows the historical spread between the two.



* 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.

The Forward P/E spread between the US and International stocks is also at 20-year highs.



* 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.

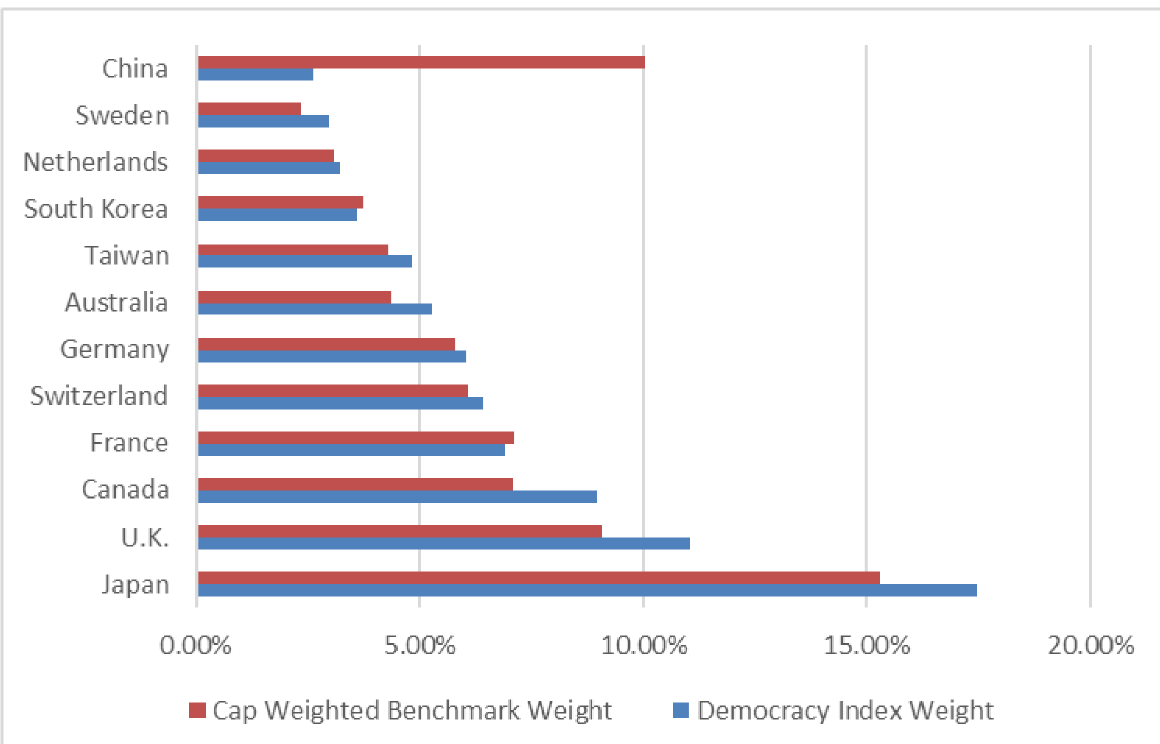
From this we can see that the spread between US and International equities was largely in the 1-3 range for most of the first decade, but started to steadily rise in 2009, in part due to central bank activities related to several quantitative easing programs.

Could this represent a "new normal" where P/E ratios are this high and spreads between US and international equities remain this wide? Doubtful. Either earnings will have to come in well ahead of consensus expectations, or prices will need to come down.

One way to play this current discrepancy is to invest in an international stock ETF. The challenge with that is that most ETFs are market capitalization weighted. This means they treat all countries and regimes as equal, only market capitalization matters. There is no factor involved to account for risks associated with authoritarian regimes – capricious policies, rule of law issues and geopolitical matters.

We sought to address this by using the Economist's Democracy Index as a means to "tilt" the portfolio away from authoritarian regimes and toward more democratic ones. By assigning a "Country of Risk" to every security, we can multiply through the market capitalization-based index weighting for every stock, times the appropriate country Democracy Score. The resulting products are then normalized so that everything totals back to 100%. The resultant index underweights China, Russia and Saudi Arabia by 70%, 60% and 72%, respectively. The impact on the largest countries in the Index can be seen below.

% Weight in Indices by Country (as of 9/30/21)



We took this systematic methodology and launched the Democracy Investments International Index on March 31, 2021. The resulting 6-month performance relative to the underlying Solactive benchmark market cap only weighted index can be seen below, along with relative performance compared to the MSCI and FTSE All World Ex-US market cap indices. The "Smart Beta" or out-performance of the Democracy strategy over the period was due in large part to under-performance of authoritarian countries.

6 Month Returns - 2021 USD	(3/31/21 – 9/30/21)
Democracy Investments International Index	**3.42%**
Solactive GBD Global Markets ex US Index	2.36%
Difference	**+106 bps**
MSCI ACWI ex US Index	2.67%
Difference	**+75 bps**
FTSE All World Ex-US Index	2.32%
Difference	**+110 bps**

Index returns are for illustrative purposes only and do not represent actual Fund performance. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index.

The Democracy International Investments Index is a proprietary index that is intended to represent the performance of securities in democratic countries. The Index begins with a universe of non-U.S. large- and mid-cap securities across 54 countries, applies a Democracy Index score to "countries of risk", then weights the securities according to market capitalization and democracy scores, resulting in higher weights in democratic countries and lesser weights in authoritarian states.

Index performance may be considered hypothetical. Hypothetical performance has inherent limitations. Democracy Investment Management maintains the Index and calculates the Index performance shown or discussed, but it does not represent actual assets. Thus, the performance shown or discussed does not reflect the impact that material economic and market factors had or might have had on decision making if actual investor money had been managed.

Doing a deeper dive, we took a look at the sector tilts that came out of this process. We are under-weighted in financial, consumer discretionary and communication services. This is offset by over-weights to industrials, materials and consumer staples.

Portfolio versus Solactive World ex-US Benchmark (4/30/2021 - 9/30/2021)

Sector	Portfolio Weight	Benchmark Weight	Difference
Financials	18.68%	19.42%	-0.75%
Industrials	13.70%	12.34%	1.36%
Information Technology	12.92%	12.48%	0.44%
Consumer Discretionary	11.11%	12.90%	-1.79%
Health Care	9.70%	9.46%	0.25%
Consumer Staples	8.98%	8.42%	0.56%
Materials	8.96%	8.35%	0.61%
Communication Services	5.58%	6.61%	-1.03%
Energy	4.90%	5.13%	-0.23%
Utilities	3.11%	2.73%	0.38%
Real Estate	2.36%	2.15%	0.20%

In conclusion, given the relative valuation difference between US and international equities, the shifting global supply chains and recent authoritarian crackdowns, investors might be wise to take a long look at a new type of indexing that accounts for the regime in which a company operates, and does so in a systematic manner. This methodology allows for a very similar return stream to the market capitalization weighted strategy, while more closely aligning with an investor's democratic values in a manner that is both systematic and transparent. For more background, see my colleague Dr. Richard Rikoski's white paper on the strategy's incentive structure at https://www.democracyinvestments.com/insights/democracy-investments-international-index.