International Equities:
Now Why Would I Do That?

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Investors have been waiting what seems like eons for international stocks to outperform their domestic counterparts. Yes, there have been fits and starts, but markets have not witnessed sustained outperformance by international holdings versus domestic companies in more than a decade. In our view, this period has further reinforced U.S. investors' home-country bias whereby investors much prefer investing in their domestic markets than in those outside their borders. International managers have felt forced to dutifully reassure their clients and prospects that the day is coming for relative outperformance of international portfolios versus domestic versions.

While this time has not come to pass, we believe there are certainly reasons to continue to be bullish on international equities as part of a larger portfolio allocation. In this paper, we will discuss several traits of international stocks and why they may be poised to enjoy a performance breakout versus their domestic peers. These timely characteristics include relative valuations, the overall opportunity set, and historical market rotations.

Relative Valuations and Growth

While valuations alone do not portend an imminent change in investment performance, to deny their importance is a mistake for long-term investors. As of Dec. 31, 2022, the trailing one-year price-to-earnings (P/E) multiple for international stocks shows they are substantially cheaper than domestic peers. The MSCI EAFE® (Net) Index, the most widely used index to represent developed markets outside of the United States,[1] is trading just under 12x earnings while both major large-cap U.S. indices (the Russell 1000® Index and S&P 500 Index) are much more expensive – approximately 18x earnings. This lower P/E ratio indicates to us that not much is expected from international stocks in the near term and that negative sentiment is built into the price.

Along with valuations, investors should consider what the growth prospects are for different areas of the global market. Importantly, recent trends bode well for foreign companies, as the trailing one-year earnings-per-share (EPS) growth percentage is over 15% for the MSCI EAFE and approximately 8% for the main U.S. indices. (For many this is probably a surprise, given the well-publicized headwinds that European countries have faced recently!) For the long-term investor, we believe these characteristics taken together point to a timely opportunity.

Broader Opportunity Set

Simply put, there are many more public companies outside the United States than domiciled within our borders: Roughly 10% domestic versus 90% outside the U.S.; however, to be fair, the United States has more than 40% of the global market capitalization.[2] To be sure, many of the world's "best" companies are located in America, but there is no shortage of excellent companies overseas. It is just as important to point out that the makeup of the international companies differs quite a bit from here at home. As of Dec. 31, 2022, while relatively expensive mega-cap technology stocks and healthcare players dominated the U.S. indices (roughly 40% of the Russell 1000 and S&P 500), international stocks tended to exhibit more cyclicality and value characteristics with financials, industrials, and materials making up about 40% of the MSCI EAFE. Given the materially larger group of publicly traded companies and sector breakdown of the MSCI EAFE, it is fair to say that diversification prospects are ripe with international stocks.

Another salient point to make regarding international opportunities in a post-COVID investment world revolves around de-globalization. We believe this phenomenon was born out of the rise of nationalist populism growing in popularity globally since 2016. In the post-pandemic world, de-globalization is moving forward with even more velocity. Because of massive supply chain issues that affected regions across the globe during the coronavirus pandemic, regions and countries are not only looking to slow down the multi-decade trend of globalization but also are looking to reverse this mega-trend altogether in some instances. The United States looking to onshore more of its semiconductor manufacturing from southeast Asia is a prime example for U.S. investors. While globalization has led to a long-term uptrend in correlations between U.S. and international stocks, de-globalization can certainly have the reverse effect – which could potentially rekindle the somewhat muted diversification benefits of international stocks over the last decade or so.

Market Rotation

Let's cut to the chase – if an investor has utilized international equities as part of a broader asset allocation over the past decade they have been quite disappointed. For instance, for the 10 years ending Dec. 31, 2022, the Russell 1000 rose 12.4%, while the MSCI EAFE rose 4.7%, annualized. Clients and advisers alike have been underwhelmed by the continual relative underperformance of international stocks versus their domestic counterparts. Since the Global Financial Crisis of 2008-09, domestic stocks have crushed their foreign brethren. With this backdrop, we believe investors need to remember the power of mean reversion. And given that in the last 50 years this is the longest run of outperformance of the S&P 500 versus the MSCI EAFE (when calculated by comparing the trailing 3-year return of each index),[3] now could be the time to revisit a portfolio's international allocation.

An appropriate analogy here would be the ongoing growth versus value debate. Growth dominated value as a factor for so long that some investors had seemingly written off value characteristics as a worthwhile portfolio constituent. But as we have seen over the past several quarters, when factors rotate, they can do so with a vengeance, and many investors without meaningful value exposure significantly underperformed. In a similar vein, we believe investors who have written off international equities risk missing out on significant return potential when the trend of domestic outperformance reverses. While mean reversion is certainly not guaranteed, when paired with other discernible and timely factors such as relative valuations, growth characteristics, and broader data sets, it can portend an excellent investment opportunity for patient investors.

[1] Source: MSCI
[2] Source: World Bank
[3] The MSCI EAFE Index was launched on March 31, 1986. Data prior to the launch date is back-tested using calculations of how the index might have performed over that time period had the index existed. There are frequently material differences between back-tested performance and actual results. Past performance -- whether actual or back-tested -- is no indication or guarantee of future performance.

About ClariVest Asset Management

ClariVest applies a behavioral-based investment philosophy in seeking alpha for clients. Our time-tested investment process combines quantitative tools with qualitative work to capture the return potential created as investors react inefficiently to significant shifts in a company's fundamental growth cycle. Portfolio managers work as a cohesive team to manage multiple equity strategies across geographies and the market cap spectrum.

About Raymond James Asset Management

Raymond James Investment Management is a global asset management company that combines the exceptional insight and agility of individual investment teams with the strength and stability of a full-service firm. Together with our boutique investment managers – Chartwell Investment Partners, ClariVest Asset Management, Cougar Global Investments, Eagle Asset Management, Reams Asset Management (a division of Scout Investments) and Scout Investments – we offer a range of investment strategies and asset classes, each with a focus on risk-adjusted returns and alpha generation. We believe providing a lineup of seasoned, committed portfolio managers – spanning a wide range of disciplines and investing vehicles – is the best way to help investors seek their long-term financial goals.

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About the authors

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Mark Pera is a Vice President and Portfolio Specialist for Raymond James Investment Management. He covers affiliates ClariVest Asset Management, Cougar Global Investments, and Scout Investments. Pera has 19 years of investment experience and joined Investment Management from Raymond James Asset Management Services, where he served as an institutional consultant and a due-diligence analyst. He began his career in 2004 at Morgan Keegan, where he served in multiple positions – including financial professional and due diligence specialist – before the firm was acquired by Raymond James in 2012. He earned a Bachelor of Science in Business Administration in Finance from Auburn University. He is a Certified Investment Management Analyst (CIMA®) and an Accredited Investment Fiduciary (AIF®).

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Bob Zimmer is a Senior Portfolio Strategist on the investment team for ClariVest Asset Management LLC. Zimmer serves as the main point of contact for clients and their consultants, responsible for maintaining and enhancing existing relationships as well as developing new ones. In addition, he plays an integral role in the firm's approach to sustainable investing and stewardship. Prior to joining ClariVest in 2012, he was a founding partner at Ten Asset Management in 2004 where he acted as both Chief Investment Officer and President. Before founding Ten, Zimmer was a portfolio manager at Investment Research Company (later Freeman Associates). He received a Bachelor of Arts degree in Economics from the University of California, San Diego.

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International investing presents specific risks, such as currency fluctuations, differences in financial accounting standards, and potential political and economic instability. These risks are further accentuated in emerging market countries, where risks can also include possible economic dependency on revenues from particular commodities or on international aid or development assistance, currency transfer restrictions, and liquidity risks related to lower trading volumes.

All indexes are unmanaged, and an individual cannot invest directly in an index. Index returns do not include fees or expenses.

Definitions

Price-to-earnings (P/E) ratios measure a company's current share price relative to its earnings per share. The ratio is used to help assess a company's value and is sometimes referred to as the price multiple or earnings multiple.

Earnings per share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a company's profitability.

Cyclical stocks have prices influenced by macroeconomic changes in the economy and are known for following the economy as it cycles through expansion, peak, recession, and recovery.

Correlation is a statistic that measures the degree to which two securities move in relation to each other.

Growth investing is a stock-buying strategy that focuses on companies expected to grow at an above-average rate compared to their industry or the market.

Value investing is an investment strategy that involves picking stocks that appear to be trading for less than their intrinsic or book value.

Factor investing is an approach to investing that selects securities based on characteristics associated with higher returns. These characteristics, or factors, can be macroeconomic factors or style factors. Macroeconomic factors are focused on broad risks across asset classes and include the rate of inflation: growth in gross domestic product; and the unemployment rate. Style factors include differences in growth versus value stocks; market capitalization, and industry sector. Factor performance refers to a focus on performance of securities within a particular factor or between groups of different kinds of factors.

Indices

The MSCI EAFE® (Net) Index measures the performance of performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the United States and Canada. The MSCI EAFE® (Net) Index subtracts any foreign taxes applicable to U.S. citizens but not applicable to citizens in the overseas country.

The S&P 500 Index measures change in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividend reinvested. The S&P 500 represents approximately 75% of the investable U.S. equity market.

The Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000® Index, which represents approximately 93% of the total market capitalization of the Russell 3000® Index.

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