SIGNATURE RESOURCES
CAPITAL MANAGEMENT

Commentary: June 2019

CHALLENGING OUR BIASES

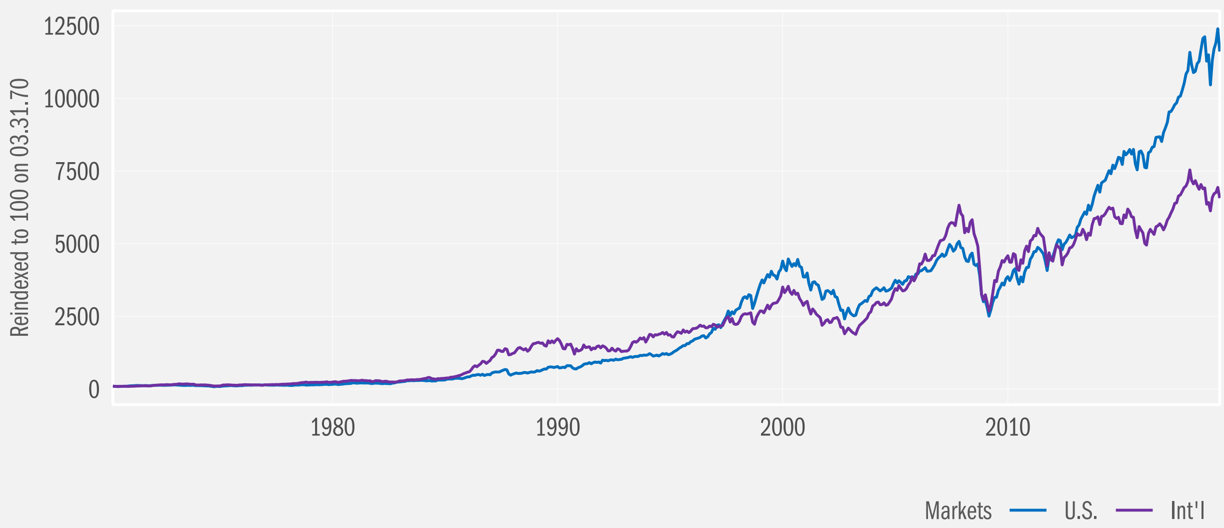
Humans can be faulted for behaviors of all sorts, and our penchants when investing are not immune to such criticism. One of the more powerful biases is our tendency to see the recent past as a fuller record than it is. As went the past few years, so must have been the past few decades, no? Not invariably, perhaps not even often so. The outperformance of the U.S. equity market seems to have many regretting international stock exposure. We find such thinking faulty both for the potential additional diversification a global portfolio presents, as well as what we may expect to prove more rewarding potential longer-term return.

Power of the Recent

In case you didn't hear, American stocks have outperformed those of other countries for some time now. By our count, for nearly a half-century. But a look at how that outperformance has occurred suggest one's take from the observation should not be that owning only U.S. stocks is a proper way to construct a portfolio. In Figure 1, we show the longer-term historical total returns of domestic and international stocks. Early on, we show only developed market stocks outside of the U.S., later incorporating emerging market stocks when a comparably suitable index began tracking them. Obvious only at the end is the fact that U.S. stocks outperformed over the long term.

Figure 1: Long-Term U.S. and International Equity Returns

From early 1970 until just a few years ago, international stocks were outperforming U.S. stocks.

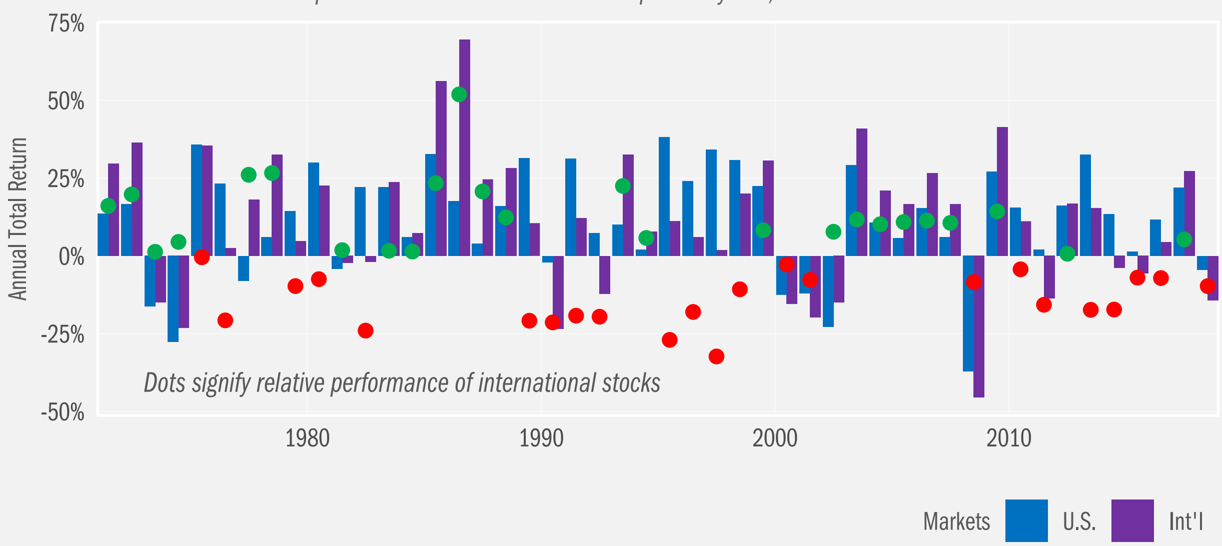


From 03.31.70 through 05.31.19. U.S. stocks are represented by the MSCI USA Index. International stocks are represented by the MSCI EAFE index until 12.31.98, after which they are represented by the MSCI ACWI ex. U.S. Index. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Indexes are unmanaged. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report.

As obvious in Figure 1 should be the fact that non-U.S. stocks had been in the lead for long periods of time (purple line higher than the blue). Figure 2 and Figure 3 show why that had been the case. Using those same data, we looked at annual returns for U.S. and international stocks. During a bit more than half of those 48 years (we only have partial-year data for 1970 and 2019), stocks outside the U.S. outperformed.

Figure 2: Comparison of Annual U.S. and International Equity Returns

International stocks outperformed U.S. stocks in 25 of the past 48 years, or 52% of the time.



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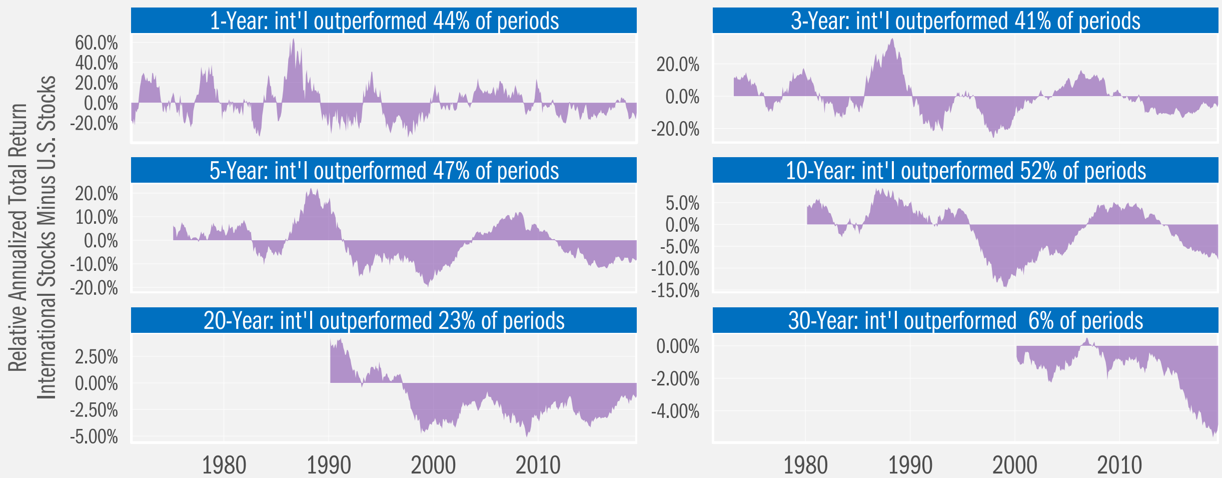
Now we're much fonder of looking at a range of longer time horizons. That's because, while we might well have a 50-year time horizon for our invested monies in our 20s and 30s, as we approach retirement or otherwise need to utilize invested monies for other purposes, a narrower outlook may be required. In Figure 3, then, we look at the 1-, 3-, 5-, 10-, 20- and 30-year historical returns for U.S. and non-U.S. stocks up to the end of each month (commonly referred to as rolling returns, with each value represents a longer-term historical view) and chart those data in the various subplots.

After reviewing the smaller charts within Figure 3, one may well arrive at the conclusion that owning non-U.S. stocks hasn't worked out so well over much of the past, given the fact that the U.S. outperformed the majority of the time across most of the periods we reviewed. Still, what should we take away from such a conclusion? Past is prologue? We don't think that's an unassailable conclusion to draw from this review (or any we've performed or encountered). First, the past half-decade remains a small sample set; we therefore should hold little confidence that such a small slice of history should prove representative over the long term future. Even more, the past contains sufficient variability to limit our enthusiasm for any specific take. We may need only to look at the difference in conclusions one might draw from reviewing only the 5- and 10-year periods (a wash, perhaps, between U.S. and international stocks), or the 1- and 3-year periods (international more often underperformed).

Figure 3: Rolling Annualized Relative Returns: International, versus Domestic

The following chart shows the difference between rolling annualized returns of international stocks, minus those of U.S. stocks. The series includes monthly intervals that represent the trailing performance for each period up to the end of that month. A positive value thus means international stocks outperformed over that period.



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Finding Value Abroad

Looking at the 20- and 30-year periods alone, however, one might think there's no sense at all in owning international stocks. That is, until one ponders the natural tendency of investments to move in cycles. While there is an understood propensity for individual/groups of securities that have outperformed to continue to outperform[1], there is a corollary understanding that outperformance can revert over longer periods of time.

Perhaps it's time then for international stocks to shine? We shouldn't presume some based solely on that relative underperformance. Instead, to further substantiate global stock ownership we should review the implications of relative underperformance. We often speak of relative value as having strong support in academic literature and practitioner success—less expensive stocks tend to outperform more expensive stocks. Given relatively reasonable fundamental metrics, non-U.S. stocks now may be seen as relatively less expensive, compared to U.S. stocks. We can see such relative value across a variety of reviews, which we intend to share in a future commentary.

In Pursuit of Diversity

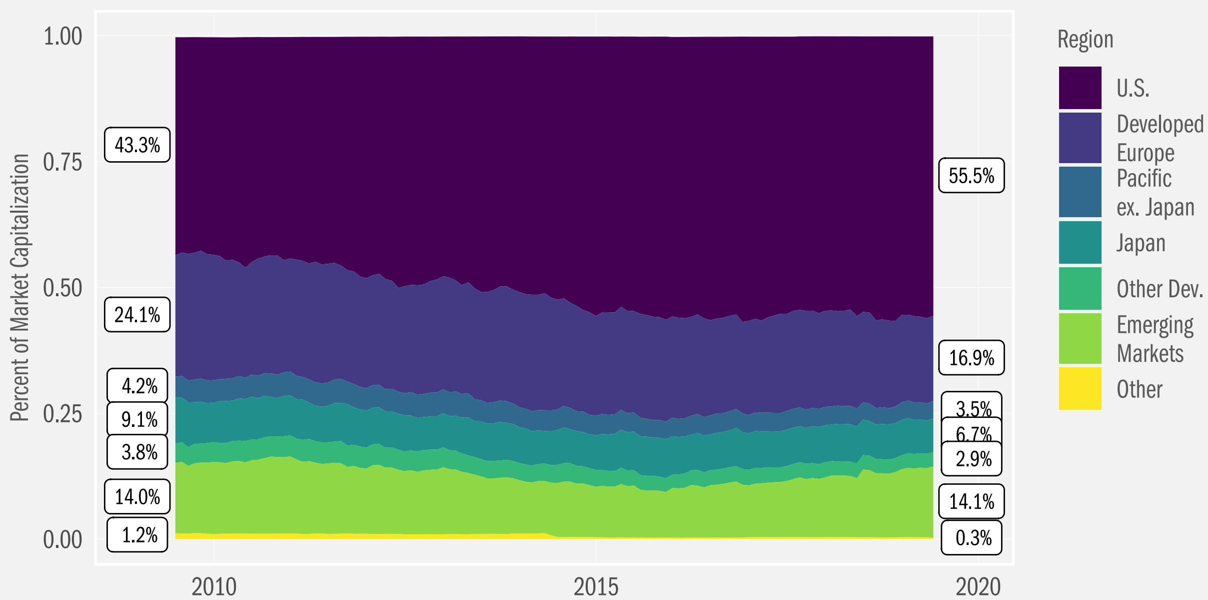
Even so, perhaps the most powerful argument for owning non-U.S. stocks remains the simplest: non-U.S. stocks may provide additional diversification to the portfolio. Though the U.S. has grown to comprise a larger portion of global equity market capitalization (see Figure 4), a substantial proportion of global stocks still

[1] We realize we are skimming the surface here regarding the concept of momentum but would rather not dive deep in order to keep this commentary a reasonable length. As always, we are happy to discuss further with those interested.

trade outside of U.S. equity markets. The upshot is that, while non-U.S. stocks may or may not outperform over various periods in the future, the potentially incremental reduction in portfolio risk they may impart in our portfolios from their contribution to portfolio diversification minimally should leave us wanting at least some exposure to them.

Figure 4: Regional Composition of Global Market Capitalization

The United States has grown proportionately larger over the past decade as Developed Europe and Japan shrank in relative size.



As of 05.31.19. Weights are estimated using index constituents provided by MSCI and market capitalization data from Bloomberg. SOURCE: SRCM using data from Bloomberg and MSCI

Reasonable Justification

We understand that clients sometimes struggle with the idea that the future is every bit as unpredictable with investing as it is with life in general. That's why it can be hard to square beliefs we may have developed from the more recent past with decisions that seem to defy those views. Perhaps lack of desire for owning international stocks or value stocks or small-cap stocks are among those fresh beliefs. In the spirit of caution, one thing we have learned from decades of investment experience is that the market has had a way of overturning newly developed opinions. And in undoing such "this time is different" thinking, the market often fortifies longer-held principles. Even as we are obliged to continue to learn from the evolution of investable markets, those longer-term principles sit at the core of our investment approach. As always, we welcome all questions regarding those principles, the market history that supports them, the variability in outcomes that they may present and the nature of our embrace of them to substantiate portfolio positioning.

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