SIGNATURE RESOURCES CAPITAL MANAGEMENT

Commentary: July 2019

REGIONAL VALUE

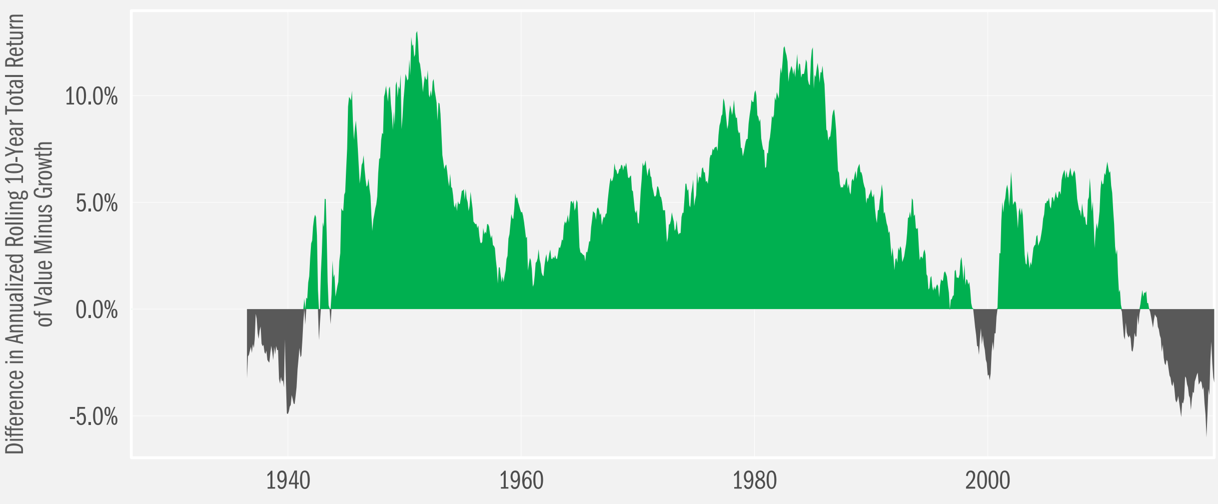
In last month's commentary, we sought to support our desire to maintain international equity exposures with an argument in favor of the greater diversification they may provide. This month we want to offer a bit of a boost to the idea using a review that should be familiar. The rather subdued relative performance of international equities has left their valuations generally lower, versus their own historical levels and relative to the U.S. market. While those gaps do not suggest immediate reward is due, in our view they bolster the idea that a portfolio inclusive of global stocks may find relative favor over the longer-term.

Supports Preference, but not Prescience

We incorporate relative valuations as a core component of our investment approach, maintaining greater interest in securities that can be seen as relatively undervalued compared to their peers, as history suggests such securities may outperform over the longer-term. Still, though present valuations are readily measurable, comparable and relatable, we may only infer from them what the future may hold. That is to say that the timing and magnitude of any eventually realized outperformance is not a feature of any observable relationship. Value might not even outperform over a sufficiently long period, as we show in Figure 1.

Figure 1: Rolling 10-Year Performance: Value, Versus Growth

Historically speaking, Value has outperformed Growth over most rolling 10-year periods. Recent underperformance confirms value outperformance is not guaranteed.



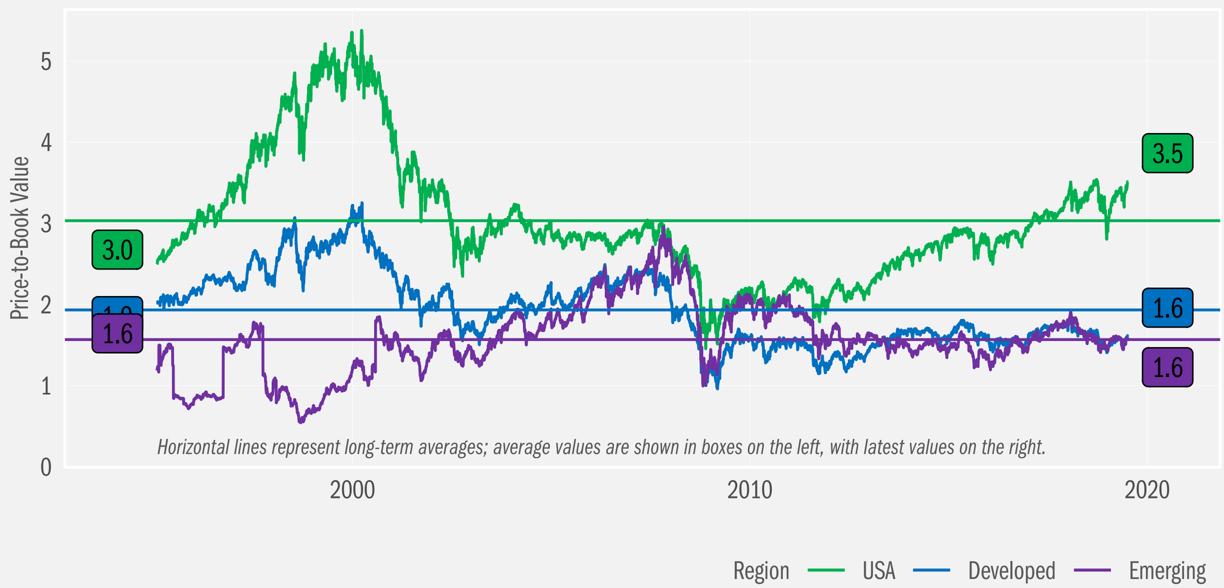
As of 05.31.19. Value stocks are represented by the Fama/French U.S. Value Research Index. Growth stocks are represented by the Fama/French U.S. Growth Research Index. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the 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. SOURCE: SRCM using data from the Data Library of the Web site of Professor Kenneth R. French

Despite the recent underperformance, however, we remain confident that portfolio tilts that favor relative value will continue to provide reasonable support for incremental gains relative to neutral exposures to the market over the longer-term. This belief stems not only from the historical register. Intuition leads us to believe that we may be better off over time, proverbially speaking, seeking to buy dollars for pennies rather than the other way around.

We may apply this same intuition to our thoughts about regional equity markets. Here, too, a range of research suggests that relatively less expensive valuations have superseded relatively more attractive returns over time. Still, the achievement of relatively more attractive returns also has been uncertain from a timing standpoint, as has been the magnitude of any relative gains.

Figure 2: Historical Price-to-Book Values for Regional Equity Markets

While developed and emerging equity market valuations remain at or below average levels, the U.S. market presently maintains an above-average level, while the gap between it and other markets has widened.



From 01.31.95 through 07.07.19. Price-to-book value is a ratio that compares market capitalization to the value of corporate assets. SOURCE: SRCM using data from MSCI via Bloomberg

Relating Valuations

There are a host of intriguing methods to contrast valuation metrics across regional equity markets. We will take a straightforward look at one valuation metric, the price-to-book (PB) ratio, as a means to convey the broader idea. The PB ratio compares the total market capitalization of a company to the assets that company owns, or in this review the sum of the market capitalizations of all the companies that comprise each regional equity market divided by the sum of the book value of their assets. In effect, we are comparing the value that public market investors place on those assets to the value of those assets used for accounting purposes. Lower PB ratios reflect relatively a more conservative assessment of value by investors, while higher PBs represent more aggressive assessments. In Figure 2, we show how PB metrics have evolved over time for U.S. market, along with those from developed and emerging markets.

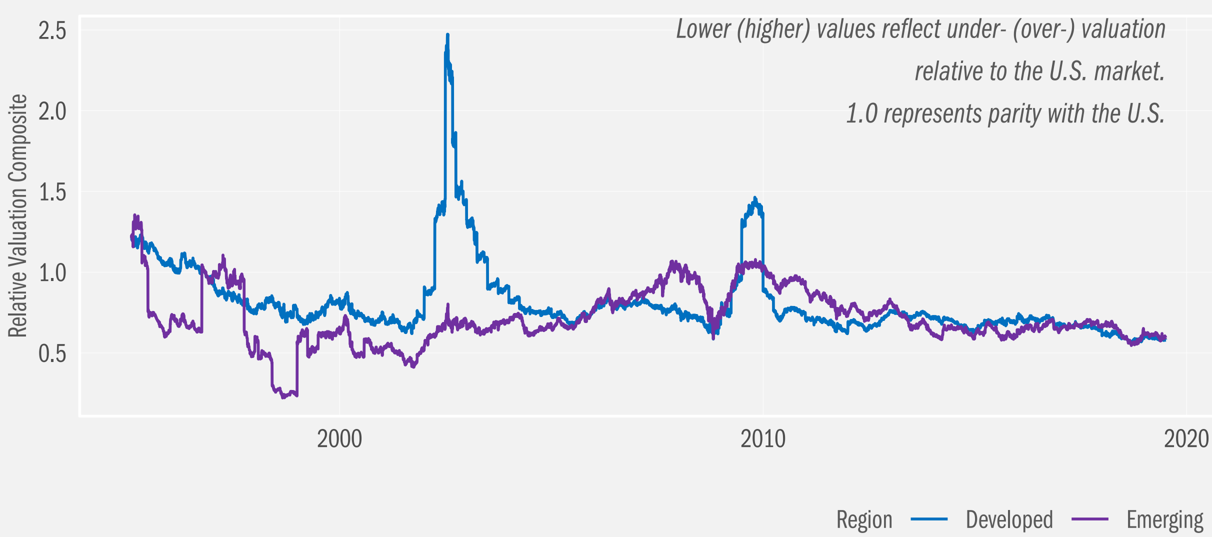
One might first notice that the values have ranged widely over time, reflecting shifting investor attitudes and underlying corporate fundamentals (for PB, the accounted-for value of corporate assets). Trends in the values for each series have diverged over time, too. The latest divergence has seen the valuation of the U.S. market, at least by the price-to-book value metric, rise steadily relative to developed and emerging market equities since the Financial Crisis of 2008-09. The divergence also has left the present valuation of the U.S. market above its average since 1995, while emerging markets rest at their long-term level and developed markets have sunk below their long-term average.

Consolidating Multiple Views

Of course, one may not wish to judge relative value by one metric alone. In Figure 3, we consolidate the relative valuations of these three markets across four different commonly used valuation ratios and find similarly supportive results[1]. To develop these data, we calculated the ratio of each non-U.S. market valuation to that of the U.S. market, with lower values representing relative undervaluation and vice-versa. Though this chart does not show the shift in valuation of each market versus itself (we are happy to provide such data, which would look like those offered in Figure 2), it does show that the composite of these metrics suggests non-U.S. equity markets have become increasingly undervalued relative to the U.S.

Figure 3: Regional Equity Market Valuations Relative to the U.S.

A composite of several valuation metrics suggests developed and emerging markets have become increasingly undervalued, versus the U.S.



From 01.31.95 through 07.07.19. Values represent average of price-to-book (PB), price-to-earnings (PE), price-to-sales (PS) ratios and dividend yields (DY) for each market relative to the U.S. PB is a ratio that compares market capitalization to the value of corporate assets. PE is a ratio that compares market capitalization to corporate earnings. PS is a ratio that compares market capitalization to corporate revenue. DY is a ratio that divides annual dividends by market price. SOURCE: SRCM using data from MSCI via Bloomberg

[1] We will be the first to admit that this review is very simple and that a much more comprehensive approach might otherwise be deployed for analytical purposes. Indeed, we incorporate a rather more sophisticated methodology for perspective purposes in our work. Even so, we find the review fitting in order to covey foundational perspective on the matter.

Still Value in Value

We continue to believe relative valuation can prove suggestive of future relative return. In the case of individual stocks, this belief powers relative tilts across our portfolios. With regard to regional markets, we do not directly incorporate relative valuation into our portfolio allocation math, as we believe the value of client comfort and familiarity with international stock ownership takes precedence over any fundamentally oriented view. The relatively uncertain nature of future relative performance across regional equity markets further erodes the incentive to adjust portfolios to any near- or medium-term shift in relative valuation.

Nonetheless, we find such data helpful during conversations with clients about ownership of international stocks, in particular after periods of underperformance of stocks outside of the U.S. Do we think such historically strong relative underperformance and undervaluation will ensure future outperformance? Perhaps not. But, we find both factors sturdy support for maintenance of non-U.S. stock positions across our portfolios.

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Fama/French U.S. Value Research Index Provided by Fama/French from CRSP securities data. Includes the lower 30% in price-to-book of NYSE securities (plus NYSE Amex equivalents since July 1962 and Nasdaq equivalents since 1973).

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