ACADIAN

PERSPECTIVES

VIEWPOINTS FROM THE ACADIAN TEAM

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OPPORTUNITIES IN INTERNATIONAL EQUITIES

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IN RECENT YEARS, U.S. EQUITIES HAVE GENERALLY OUTPERFORMED STOCKS ELSEWHERE IN THE WORLD. We believe this trend has led many U.S. investors to focus primarily on domestic equities, leaving them under-allocated to international stocks relative to long-term target levels. Some investors have no international allocation at all, ignoring opportunities that are present in developed markets outside of the U.S. We believe that relative valuations offer good reason for U.S. investors to now consider restoring or increasing their international equity allocations, and we highlight the attractiveness of accessing these markets via active strategies.

CURRENT VALUATIONS

Valuations suggest that it could be an ideal time to increase exposure to international stocks. MSCI EAFE (Europe, Australasia and Far East) represents a conventional international benchmark for U.S.-based investors. Based on several common valuation metrics, stocks in this index are currently trading at an average 30% discount to the MSCI USA index, a close proxy for the S&P 500. (Table 1) In contrast, since the mid-1970s EAFE stocks have traded nearer to a 10% average discount. EAFE equities look particularly cheap relative to the U.S. on the basis of Price/Book, Price to Cash Earnings, and Dividend Yield. EAFE's current valuation discounts are on par with or larger than their averages from the most recent 10 years.

EAFE's current valuation discounts in part reflect the recent relative strength of U.S. equities, evident in Figure 1.

TABLE 1

MSCI EAFE versus MSCI USA indices

	Price/Earnings	Price/Book	Price/Cash Earnings	Dividend Yield
Current Valuations				
MSCI EAFE	19.9	1.7	10.1	3.1
MSCI USA	24.4	3.0	14.2	2.0
EAFE Discount vs. USA				
Current	-19%	-46%	-29%	-56%
10-Year Average	-11%	-35%	-23%	-58%
Jan 1975 - Mar 2017	13%	-22%	-17%	4%

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Since mid-2008, U.S. equities have outperformed EAFE by 7.7% annually, of which 3% per year is due to dollar appreciation. This is unusual – since 1970, the dollar has depreciated 1% annually relative to EAFE currencies. This recent dollar strength, should it continue, will pose possible pricing challenges for U.S. exporters and profit headwinds for domestic companies with international operations.

As Figure 1 suggests, the outperformance of U.S. equities versus EAFE has not been a consistent phenomenon. Over the last 47 calendar years, EAFE has outperformed in 25. Figure 2 shows the annual outperformance of EAFE relative to U.S. It is interesting to note that out- and under-performance of either equity region often persists for a few years then reverses. This pattern provides diversification opportunities for U.S. or EAFE portfolios.

FIGURE 1

MSCI indices cumulative returns

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FIGURE 2

MSCI EAFE outperformance versus MSCI USA

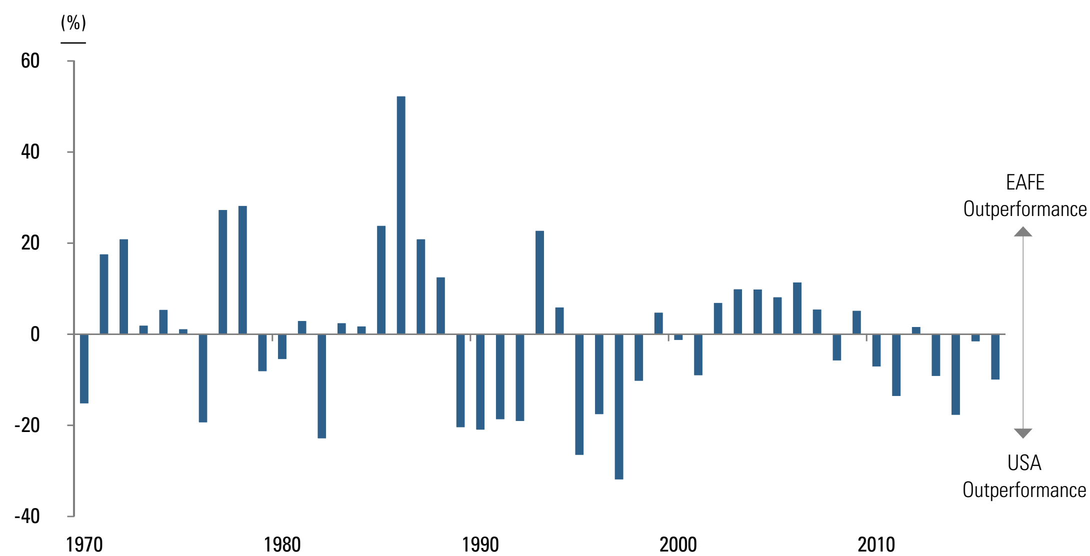

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TABLE 2

eVestment U.S. Large Cap and EAFE Core Equity Universes five years of excess returns as of December 31, 2016

	U.S. Large Cap vs. S&P 500 Index	EAFE vs. MSCI EAFE (net) Index
Percentile		
5th Percentile	1.97%	6.23%
25th Percentile	0.45%	2.66%
Median	-0.63%	1.14%
75th Percentile	-1.72%	-0.09%
95th Percentile	-3.86%	-1.61%
Number of Observations	**1055**	**108**

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ACTIVE MANAGEMENT IN NON-U.S. MARKETS

Struggles of active U.S. equity strategies in recent years have been well documented. Table 2 summarizes the evidence, showing the distribution of five-year, net-of-fee performance for 1,055 U.S. Large Cap Equity strategies found in eVestment. The median manager underperformed the index by 0.63%.

EAFE equity managers, in contrast, have demonstrated superior ability to add value. Over the same period, the median EAFE Core Equity strategy added 1.14% per year, net of fees. We believe the reasons for greater success include less efficiently priced securities, a broader opportunity set, and ability to add value through country and currency selection—all motivations for taking an active approach in accessing non-U.S. markets.

CONCLUSION

Several years of U.S. equity outperformance have drawn investor attention away from international markets. We see the resulting relative valuation discount in EAFE equities as compelling reason to consider increasing international exposure now. And we see international markets as offering potentially promising ground for active, systematic approaches, as they have throughout Acadian's 30 year history.

BIOGRAPHY

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Brian joined Acadian in 1990. Prior to his current role as Senior Portfolio Manager, he served as Director of Portfolio Management overseeing portfolio management policy, as well as co-Director of Research responsible for developing and applying investment techniques to evaluate markets and securities. Before joining Acadian, he worked in the Systems Planning Group at Bank of New England and as a Senior Systems Analyst at Mars Incorporated. He is a CFA charterholder and a member of the Boston Security Analysts Society. Education: B.S., Accounting, Lehigh University; M.S., Management, MIT.

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