ACG Insights: Capitalizing on Opportunities in Global Equities

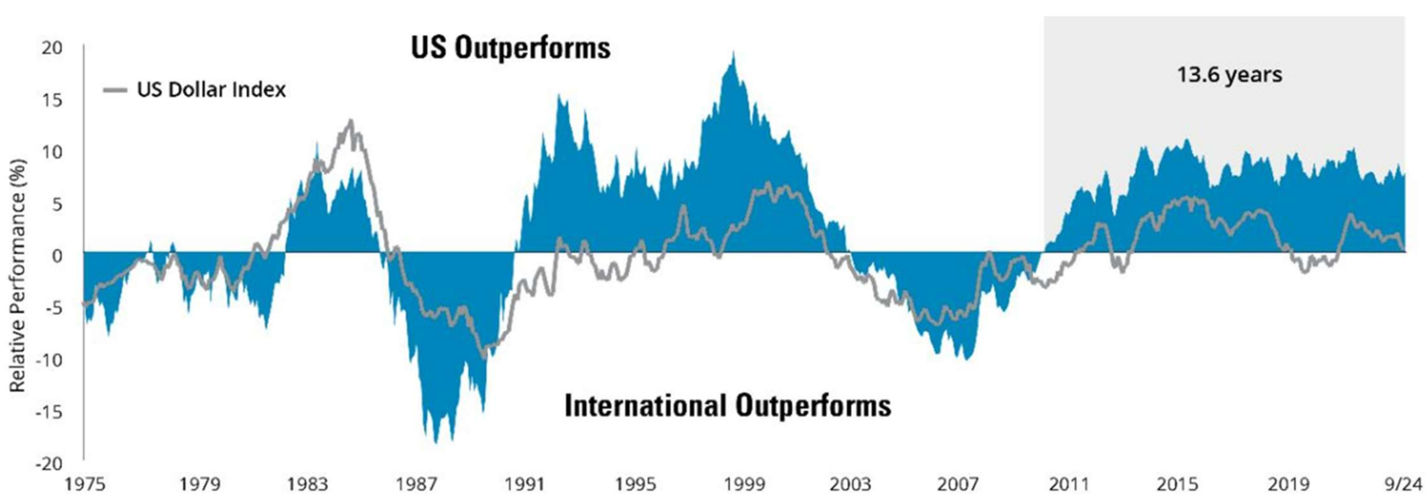
Executive Summary

- **Despite recent underperformance, investing in international equities can help minimize portfolio volatility, capitalize on market leadership changes, and expose investors to global industries that are less dominant in the U.S.**
- **For the most part, foreign stocks offer lower valuations currently, currency diversification, and have historically performed similarly to U.S. equities in higher interest rate environments**
- **A strategic allocation to international stocks and regular rebalancing can help promote portfolio resilience and benefits from global economic and market developments**

Introduction

The past decade has showcased impressive U.S. stock market performance. Understandably, investors have grown frustrated with their international equity allocations that have not kept up with the steady and elevated returns of the U.S. Forget about diversification! Why not go all-in on U.S. equities? This natural tendency for U.S. investors to overweight assets within their own borders, known as home country bias, has been exacerbated by recent stellar performance from U.S. stocks.

Exhibit 1: S&P 500 vs. MSCI World ex U.S. 5-Year Monthly Rolling Returns[1]



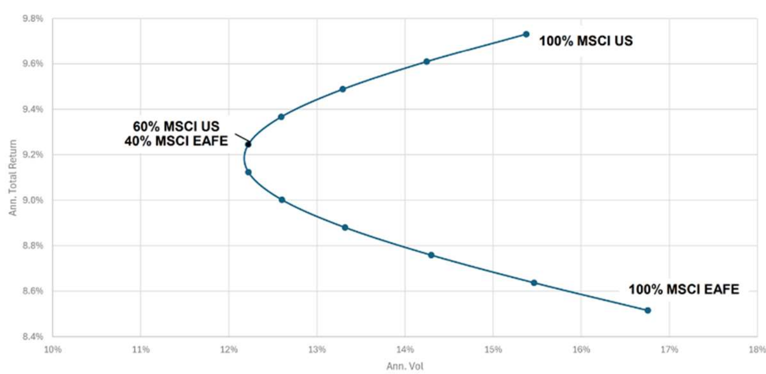
[1] Morningstar, Bloomberg, Hartford Funds. As of 9/30/2024.

Our latest ACG Insights explores the importance of global diversification, highlights the potential opportunities in foreign markets, and offers practical guidance for constructing a geographically balanced investment portfolio. Adopting a global perspective can assist investors in strengthening portfolio resilience, identifying undervalued assets, and improving positioning for future market cycles.

Risk Reduction Through Geographic Exposure

One of the primary advantages of international diversification lies in its potential to reduce portfolio volatility (Exhibit 2). Because geopolitical, economic, and market-specific risks differ from region to region, declines in one market might be offset by gains or stability in other areas. For example, during the U.S. financial crisis of 2008, certain international markets, such as emerging Asia, experienced less severe economic contractions as they were largely insulated from the U.S. housing collapse. By investing across regions, investors often reduce localized downturns and obtain more steady returns.

Exhibit 2: Efficient Frontier Between Domestic and International Equities[2]



Cyclicality of Market Leadership

Market leadership, the dominance of a particular region or country, is inherently cyclical. Over the past seven decades, there have been distinct periods where international equities outperformed their U.S. counterparts (Exhibit 3). For example, in the early 2000's, industrialization and China's rapid economic growth boosted the equity returns of commodity exporting countries such as Australia and Canada. However, U.S. markets surged in the 2010's on the back of technology sector dominance and accommodative monetary policy.

Exhibit 3: Ranking Equity Performance by Decade[3]

	1950s	1960s	1970s	1980s	1990s	2000s	2010s
BEST	JPN	AUS	JPN	SWE	USA	AUS	USA
	DEU	JPN	CAN	JPN	CHE	CAN	SWE
	FRA	CAN	AUS	GBR	SWE	CHE	DEU
	ITA	EWB	GBR	ITA	FRA	EWB	JPN
	EWB	USA	EWB	EWB	GBR	SWE	FRA
	USA	SWE	SWE	FRA	EWB	GBR	CHE
	AUS	DEU	USA	DEU	DEU	FRA	EWB
	GBR	GBR	CHE	USA	CAN	USA	GBR
	SWE	CHE	FRA	CHE	AUS	DEU	CAN
	CAN	FRA	DEU	AUS	ITA	ITA	ITA
WORST	CHE	ITA	ITA	CAN	JPN	JPN	AUS

Country
United States
Sweden
Germany
Japan
France
Switzerland
Equal-Weighted Basket
United Kingdom
Canada
Italy
Australia

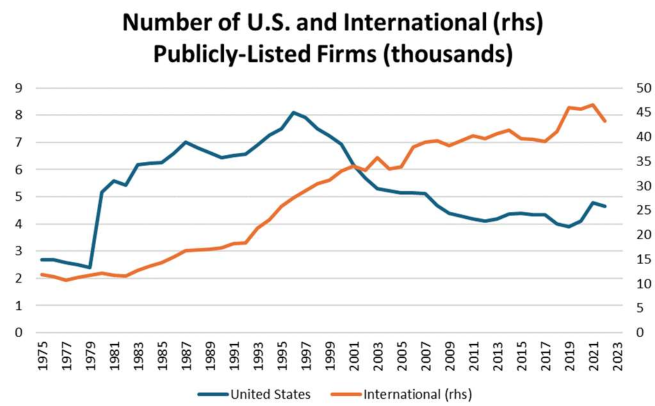
[2] Lazard. As of 8/31/2024. Since inception 12/31/1969.
[3] Global Financial Data, Inc.

Exhibit 3 underscores the danger of extrapolating recent trends into the future. Investors in Japanese equities in the late 1980’s were likely confident of future prospects following decades of strong returns and the largest country weight in the MSCI World Index. This period was followed by Japanese equities experiencing some of the poorest returns globally during the subsequent few decades. The Nikkei, a stock market index for the Tokyo Stock Exchange, only recently surpassed its 1989 record high in February of last year. Not that this is expected for U.S. equities, but it emphasizes the significance of being prepared for market shifts.

Exploring the Global Opportunity Set

Another benefit of investing globally is the broader opportunity set both in the number of publicly listed firms as well as in leading industries. Compared to 4,600 companies listed in the U.S., over 43,000 companies are listed abroad (Exhibit 4). Furthermore, the number of international listings is increasing, in contrast to the declining trend observed in the U.S.

Exhibit 4: Larger Opportunity Set Globally[4]



Certain industries outside of the U.S. are more dominate or are at least very competitive on the global stage. For example, Danish multinational pharmaceutical company, Novo Nordisk is a leader in diabetes and weight-loss therapies with their GLP-1 drugs Ozempic and Wegovy. In addition, some of the world’s leading luxury goods companies are European including Hermès, Richemont, and LVMH. All have been resilient and strong performers over the long term. Allocating abroad can take advantage of these sectoral strengths, which might not be as well-represented in domestic markets.

Exhibit 5: The Valuation Disparity is at an Extreme[5]

Sector Neutral Valuation of MSCI EAFE vs. MSCI USA

Largest EAFE Discounts

Cumulative Returns	Dec 74 – Dec 79	Jul 92 – Jul 95	Nov 01 – Nov 06
MSCI USA	11.7%	12.3%	5.5%
MSCI EAFE	**17.9%**	**16.0%**	**14.4%**

Largest EAFE Premiums

Feb 89 – Feb 92	Apr 94 – Apr 99	Oct 09 – Oct 19
16.0%	**27.2%**	**13.0%**
-4.3%	8.7%	5.4%

[4] World Bank Group, World Federation of Exchanges Database. As of 12/31/2022.

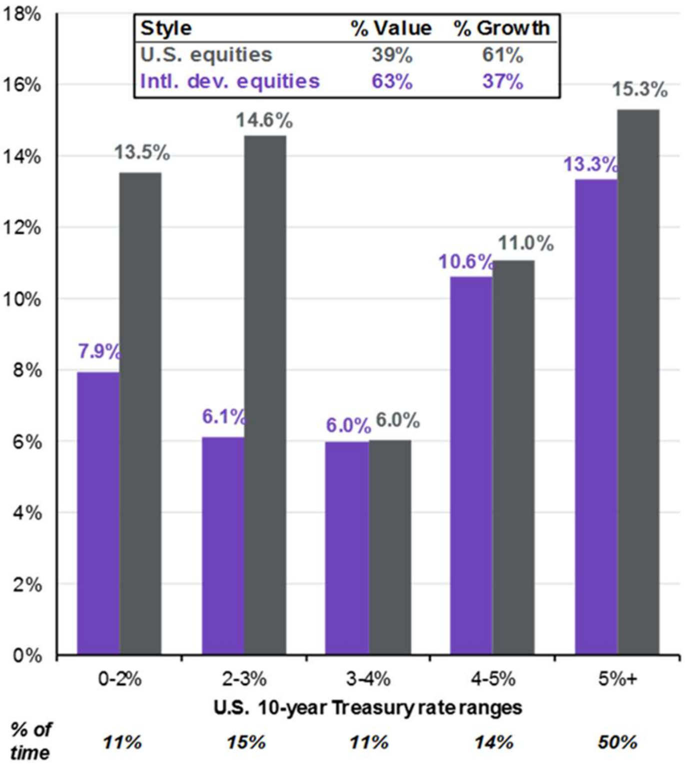
[5] Brandes, MSCI via FactSet. As of 9/30/2024. Aggregate valuation discount based on the average of each individual metric’s (price/book, price/earnings, price/cash flow) valuation discount of the MSCI EAFE index relative to MSCI USA.

Cyclical Case – Valuation

Along with the structural benefits of investing globally, there are a few current reasons international stocks look attractive. On virtually any valuation metric international equities are trading at steep discounts to U.S. equities. The aggregate sector neutral valuation discount of the MSCI EAFE versus MSCI USA over time is shown in Exhibit 5. There are significant observations to be drawn from the graph and tables. For starters, international equities have not always been valued less than their U.S. counterparts and have, at times, commanded significant premiums. Secondly, at present, international equity valuations sit near their largest-ever discounts. Finally, the tables at the bottom of the figure illustrate that steep discounts have historically led to outperformance for international relative to U.S.

A common and fair rebuttal to the attractiveness of valuation discounts is that these valuation gaps can and have persisted for a long time, in this case nearly a decade. While short-term market moves are difficult to predict, history suggests that mean reversion often brings such valuation disparities back into balance.

Exhibit 6: Equity Performance Under Various Interest Rate Conditions[6]
Annualized total return by 10-year Treasury rate ranges, USD, 1979 - present



Cyclical Case – Higher for Longer

Another rationale for the potential attractiveness of international equities is that the interest rate environment of the past decade appears to have shifted. For years, low interest rates benefitted the technology and growth-oriented U.S. market. And then inflation struck, followed by climbing interest rates, with the 10-year treasury now yielding around 4.5%. How might this help foreign stocks?

International markets exhibit a distinct composition compared to the U.S., characterized by increased exposure to cyclical value-oriented sectors, including financials, materials, industrials, and energy. Historically, regional performance has been more balanced during elevated interest rate environments (Exhibit 6). Despite a decline in inflation from its peak, global central banks, including the Federal Reserve, are anticipated to keep interest rates elevated in the short term to further manage inflation, which should benefit foreign stocks.

Cyclical Case – The Dollar

The performance of the U.S. dollar is an important factor influencing global equity performance. Looking back at Exhibit 1, periods of international underperformance have aligned with dollar strength. The dollar has

[6] J.P. Morgan as of 11/30/2024

exhibited considerable strength recently, owing to relatively high interest rates, and additional rate cuts seem doubtful given economic resilience. Nevertheless, much like valuation premiums, dollar strength is not a surety into the future, as there is a long-term concern of the U.S. running both a current account and fiscal deficit weakening the dollar. Currency movements are challenging to predict; however, the possibility of a weakening dollar could enhance the appeal of international equities.

Strategic Allocation and Monitoring

For most equity investors, a thoughtful allocation to international stocks is advisable, but at what percentage? The traditional financial-theory technique for global allocation is to invest proportionally based on market capitalization. This strategy presupposes that markets are reasonably efficient and that stock prices reflect all available information, analysis, and investor expectations. Exhibit 7 indicates that the neutral weighting for the equity portion of a portfolio is 67% U.S. 33% international as of 12/31/2024. While not perfect, this is a suitable starting point that can be modified with investor preferences and outlook. In addition, the allocation should be tailored to the portfolio's time horizon, risk tolerance, and investment goals.

Exhibit 7: Share of Global Market Capitalization[7]

% weight in the MSCI All Country World Index, USD, monthly

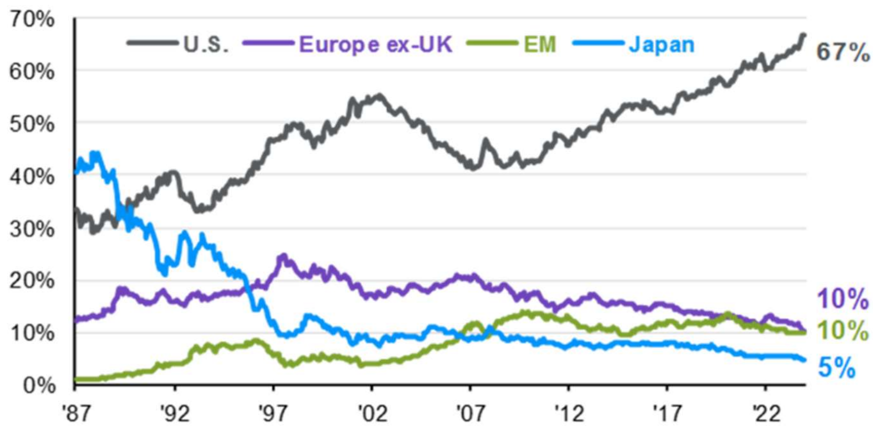


Exhibit 7 illustrates that market fluctuations will cause the proportion of international equities to vary over time. Regular portfolio monitoring and rebalancing are crucial for sustaining the intended allocation and achieving the diversification benefits international markets can provide.

Conclusion

Notwithstanding the disappointment of short-term underperformance, the long-term advantages of international diversification are evident. What has occurred will not necessarily persist. By adopting a balanced and disciplined approach, investors can better prepare their portfolios to weather future market cycles and capture potential opportunities across the global landscape. As markets evolve, a steadfast commitment to global diversification stands as a wise course toward achieving sustainable growth and shielding against the shadows of an uncertain future.

[7] J.P. Morgan as of 12/31/2024

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