INVESTISSEURS SANS FRONTIÈRES (INVESTORS WITHOUT BORDERS)

HIGHLIGHTS:

- While the U.S. is home to several of the world's most profitable and innovative companies, this does not guarantee superior risk-adjusted returns relative to international stocks.
- The number of stocks listed on U.S. exchanges fell by nearly 50% from 1996 through 2016, with the famed Wilshire 5000 Total Market Index now holding well below 4000 stocks. At the same time, the number of listed stocks outside the U.S. increased by over 30% from roughly 23,000 in 1996 to over 33,000 currently.
- U.S. equities' representation in the MSCI All Country World Index is over three times the representation of the U.S. in the global economy. At the same time, emerging markets equities account for just under 11% of total worldwide market capitalization, despite generating nearly 60% of all global economic activity.

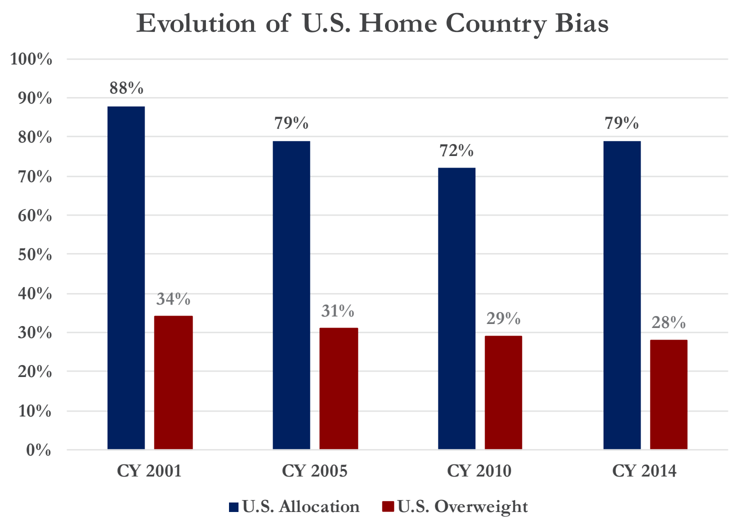
The world's largest manufacturer of smartphones claims a market share that is roughly twice as large as its closest competitor. The world's largest e-commerce provider serves well over 400 million active users, while also generating strong returns in its growing cloud computing business. The world's largest auto manufacturer boasts combined sales of over 10 million vehicles in more than 150 countries per year. In addition to their status as market leaders and innovators, these companies share another critical characteristic: They are each headquartered outside of the United States. Indeed, the companies described above are not Apple, Amazon, and General Motors, as some might have guessed. They are Samsung, Alibaba, and Volkswagen, and U.S. investors can only participate directly in the success of these companies by going outside their own borders.

The topic of global equity allocation is as important now as it has ever been. In an economic environment constrained by challenging growth prospects, high debt levels, and considerable political uncertainty, investors must be willing to expand their horizons if they want to enhance their returns. Most U.S.-based investors struggle to do that, instead demonstrating a persistent tendency to overweight their home country in their global equity portfolios. Such positioning has provided clear benefits to U.S. investors in recent years, as returns on the S&P 500 have dwarfed those of the international developed and emerging equities markets. However, while extrapolating the recent past to the future is tempting, it is also very dangerous. Similarly, while this "home country bias" generally creates comfort and confidence for investors, it does not necessarily produce diversified, efficient, risk-controlled portfolios.

HOME COUNTRY BIAS IN CONTEXT

Home country bias is a persistent phenomenon around the world. U.S. investors are particularly prone to favor domestic equities relative to their actual weight in an index of global stocks, as illustrated below.

FIGURE 1



SOURCE: VANGUARD; INTERNATIONAL MONETARY FUND; HIGHLAND ASSOCIATES

Extensive research on the subject has identified several rationales for the endurance of home country bias. First, investors' familiarity with their local economy and capital markets tends to drive inflated projections for future growth and price appreciation. In addition, the perception that the U.S. offers the most comprehensive, advanced, and hospitable capital markets in the world perpetuates the home country bias. Differences in corporate governance also support strong domestic investment, as foreign investing is typically characterized by higher costs and lower transparency. Beyond that, the increasingly globalized nature of the world economy and capital markets may limit foreign investment, as market participants can easily gain exposure to international markets through large multinational corporations that are domiciled locally. Liability hedging also incentivizes local investment, as many investors prefer to match assets with liabilities as closely as possible. Similarly, the seemingly unpredictable nature of foreign currency movements – and their occasionally outsized impact on total returns – tends to keep investors at home.

Beyond these general justifications, U.S. investors need only look to recent history for confirmation that home country bias offers significant benefits to their portfolios. U.S. equities have clearly outperformed their international peers in the years following the Global Financial Crisis, with the S&P returning over 14% on an annualized basis from 2009 through 2016, compared to 7% and 8%, respectively, for international developed and emerging markets.

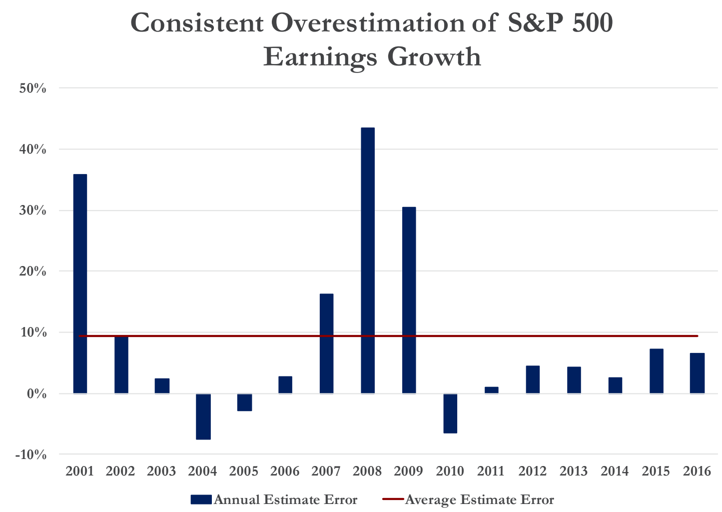
Of course, while these arguments convey a convenient narrative, they do not represent a coherent and comprehensive investment process. As discussed in prior research publications, Highland believes strongly that investors must look beyond generalizations and heuristics in forming their outlooks and allocating their capital. In this context, it is important to understand the merits of investing beyond our borders.

DEBUNKING THE HOME COUNTRY BIAS

It is certainly natural for investors to hold favorable expectations based on their familiarity with their own environment, but this is also incredibly simplistic. While the U.S. is home to several of the world's most profitable and innovative companies, this does not guarantee superior risk-adjusted returns relative to international stocks. At their core, equity prices are a function of earnings growth, valuations, dividend yields, and interest rates. Looking ahead to the remainder of 2017, consensus expectations indicate that aggregate earnings on the S&P 500 Index will grow by roughly 10%. However, earnings outside the U.S. are expected to grow even faster. The Institutional Brokers' Estimate System (IBES), a service that aggregates analysts' published estimates, indicates that earnings in Europe, Japan, and emerging markets will grow by 19%, 15%, and 20%, respectively, in 2017.

Recent history indicates that analysts have a persistent tendency to overestimate U.S. earnings growth in the near term. As illustrated in ***Figure 2***, consensus expectations for S&P 500 earnings growth at the start of each of the last 16 years have exceeded actual earnings growth for the year 13 times, with average estimates surpassing actual growth by 9.7% over the period. If this trend continues, the earnings deficit in the U.S. relative to international developed and emerging markets could grow even larger. Relatively rich valuations and the prospects for rising interest rates in the U.S. also cast doubt over the efficacy of the home country bias in the near to intermediate term.

FIGURE 2



SOURCES: FACTSET, HIGHLAND ASSOCIATES

FIGURE 3

Trends in U.S. Stock Market Composition

	1976	1996	2016
Number of Listed Companies	4,796	7,322	3,671
Market Capitalization (billions)	$2,975	$12,322	$25,303
Gross Domestic Product (billions)	$6,325	$11,769	$18,565
Average Market Capitalization (billions)	$0.62	$1.68	$6.89
Corporate Profits/GDP	6.9%	6.2%	8.9%
Average Age as a Listed Company (years)	10.9	12.2	18.4

SOURCES: CREDIT SUISSE; JOURNAL OF FINANCIAL ECONOMICS (DOIDGE, KAROLYI, STULZ); HIGHLAND ASSOCIATES

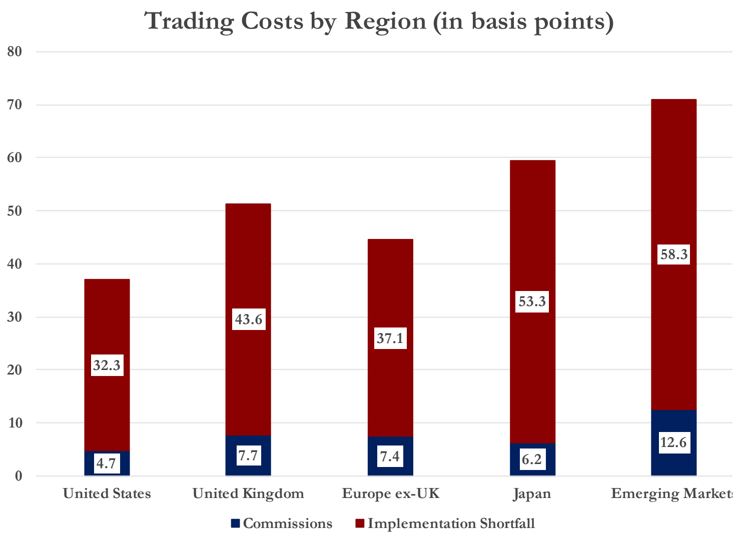
Regarding the U.S. stock market's perceived status as more advanced and more complete than other markets, the data present some truly troubling trends. In a recent note to clients, Credit Suisse's Michael Mauboussin noted that the number of stocks listed on U.S. exchanges fell by nearly 50% from 1996 through 2016. In fact, the famed Wilshire 5000 Total Market Index now holds well below 4000 stocks! A summary of Mr. Mauboussin's findings in ***Figure 3*** illustrates important changes in market composition and provides clues for their implications for investors.

A strong wave of mergers and acquisitions and a more cumbersome regulatory burden have led to increased delistings (sales to public and private buyers) and decreased new listings (initial public offerings). As a result of the substantial decline in overall listings, the "survivors" are more likely to be older, more established, more profitable companies. They are also more likely to be thoroughly understood by both sell-side research analysts and institutional money managers. In effect, this massive decrease in the supply of available stocks has increased market efficiency, thereby reducing potential alpha for U.S. equity investors. At the same time, the number of listed stocks outside the U.S. *increased* by over 30% from roughly 23,000 in 1996 to over 33,000 currently. This significantly larger opportunity set in non-U.S. markets is helpful in explaining the relatively higher alpha potential in international equities markets.

Regarding fees, it is true that the U.S. remains the most cost-efficient market in the world, consistent with its unmatched liquidity. However, international markets have made significant progress in narrowing the gap. Over the past ten years, the median bid-ask spread for stocks in the MSCI EAFE Index (a proxy for developed markets outside the U.S.) and the MSCI Emerging Markets Index have declined by nearly 50% and 60%, respectively. Other associated trading costs also indicate a declining differential between the U.S. and the rest of the world.

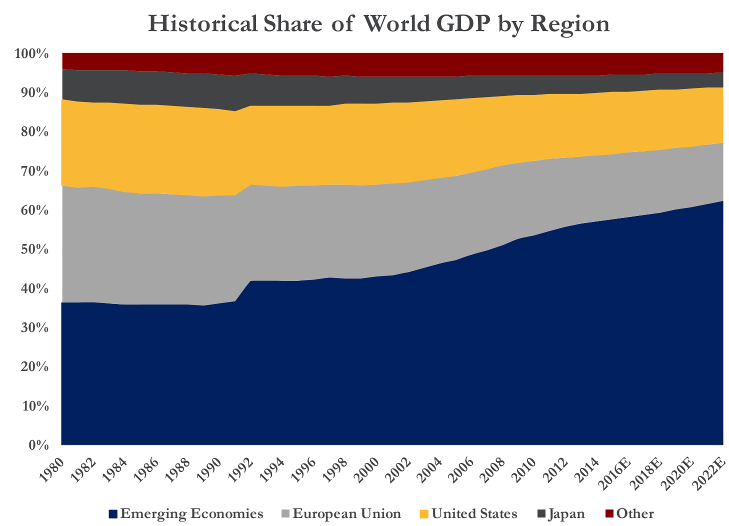
Figure 4 highlights two major sources of trading costs. As illustrated on the following page, commissions charges are virtually indistinguishable for most major developed markets, with emerging markets only slightly higher. Implementation shortfall – a measure of slippage that captures the difference between an investor's decision price (where there want to buy or sell) and their ultimate execution price (where they actually buy and sell) – also shows that markets outside the U.S. are operating at only slightly less efficient levels. Finally, the chart below actually overstates trading costs for many institutional managers, who generally emphasize price and execution discipline and should be expected to report trading costs well below the broader averages.

FIGURE 4



SOURCE: INVESTMENT TECHNOLOGY GROUP; HIGHLAND ASSOCIATES

FIGURE 5



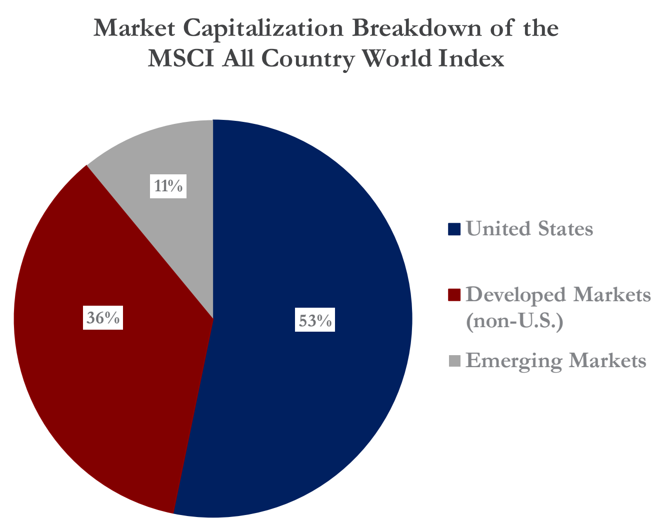
SOURCE: INTERNATIONAL MONETARY FUND; HIGHLAND ASSOCIATES

Regarding regional exposures, many investors believe that investments in U.S.-domiciled multinational corporations are all that are required to gain adequate international exposure. While these investments do serve to capture a portion of growth opportunities driven by factors and conditions that are less correlated with U.S. economic activity, portfolios that rely solely on U.S. multinationals will still fall short of capturing underlying economic reality. According to FactSet, 70% of the aggregate revenues of S&P 500 Index constituents is derived from the U.S., while 30% is generated abroad.

Figure 5 shows that actual economic activity is far more skewed toward international markets than is captured by S&P 500 stocks. In fact, the entirety of U.S. GDP accounts for less than 16% of total global GDP on a purchasing power parity basis, while emerging economies are expected to eclipse 60% of global GDP in the next few years. Put simply, investors who do not invest beyond their borders are unnecessarily limiting their opportunity set while also failing to capture key shifts in the global financial order.

Another important dichotomy is illustrated by comparing GDP with total market capitalization in different regions of the world. ***Figure 6*** indicates that U.S. equities' representation in the MSCI All Country World Index – the most widely used proxy for global equities – is over three times the representation of the U.S. in the global economy. At the same time, emerging markets equities account for just under 11% of total worldwide market capitalization, despite generating nearly 60% of all global economic activity.

FIGURE 6



SOURCE: MSCI; HIGHLAND ASSOCIATES

Perhaps the most pivotal takeaway from these criticisms of home country bias is that investors should constantly seek to expand, rather than constrain, their opportunity set. In searching beyond their borders, investors can access a far greater universe of stocks that offer the important benefit of having lower (or limited) correlations to the drivers of U.S. economic activity. Highland believes the relatively lower efficiency in non-U.S. markets allows for a more favorable stock-picking environment, increasing the likelihood of outperformance.

LOOKING FORWARD

Sound investing is, among other things, an exercise in managing emotions and maintaining discipline. Successful investors must challenge themselves to go beyond what makes them comfortable, and instead seek to discover what is not broadly understood. Of course, acknowledging and accounting for inherent biases is only part of the process for successful investors. In Part Deux of this *Insight*, we will provide a thorough examination of current market conditions to further bolster the case for investing beyond our borders. Specifically, we will discuss in detail the key drivers of long-term equity returns, including earnings growth, valuations, interest rates, and dividend yields. We will also examine portfolio implications associated with strategic allocations outside of the U.S. Stay tuned! Or, as they say in France, *restez à l'écoute*!

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