HIGHLAND

INSIGHT
JUNE 2017

INVESTISSEURS SANS FRONTIÈRES, PART DEUX (INVESTORS WITHOUT BORDERS, PART TWO)

HIGHLIGHTS:

- Trailing 10-year earnings are a full standard deviation below their historical average for U.S. equities and more than two standard deviations below average for international developed and emerging market earnings. While international profits are not guaranteed to mean revert higher, there appear to be several catalysts in place.
- The current cyclically adjusted price-to-earnings ratio for U.S. stocks is well over one standard deviation above average, but valuations for international developed and emerging market equities are well below their historical averages. Higher valuations in the U.S. should signal weaker relative returns over the long-term.
- There are currently more dollars seeking fewer U.S. stocks than at any point in history, and it stands to reason that delivering alpha in such an environment will be difficult.

"Dans les champs de l'observation le hasard ne favorise que les esprits préparés."

French scientist Louis Pasteur was a pioneer in the study of microbiology who is perhaps best remembered for the invention of pasteurization. We take it for granted today, but this process for destroying bacteria and other contaminants found in milk and wine (among other foods and drinks) saved thousands of lives in the 19th century. While Mssr. Pasteur made several other important contributions to public health, he is best remembered as a student dedicated to questioning current theories and doctrines in search of undiscovered truth. As investors, we can learn a lot from Mssr. Pasteur and his remark highlighted above, "In the field of observation, chance favors the prepared mind."

PREPARING FOR OPPORTUNITY

In ***Part I*** of this *Insight*, we examined the home country bias and investors' tendency to favor their local markets when allocating their capital. In our qualitative analysis, we showed that many of the rationales supporting the home country bias are overly simplistic. Of course, acknowledging and accounting for inherent biases is only part of the process for successful investors. An emphasis on quantitative analysis – including close and continuous reviews of market conditions – is also necessary to identify timely opportunities. In this follow-up, we will examine current conditions in the economies and equity markets of U.S., international developed, and emerging markets as the quantitative basis for significant allocations beyond the U.S.

INVESTING FOR THE TOTAL CLIENT

- *Investment services*
- *Reporting services*
- *Business services*

ABOUT OUR FIRM

Highland Associates, Inc. is an independent institutional investment advisor headquartered in Birmingham, Alabama. Highland was founded specifically to help develop, implement and maintain investment management programs for institutions. We serve a national client base of investors including not-for-profit healthcare organizations, foundations, endowments, defined benefit plans, defined contribution plans, and insurance portfolios. As of March 31, 2017, we serve as investment consultant on approximately $20 billion in assets. Please visit the website at www.highlandassoc.com to learn more.

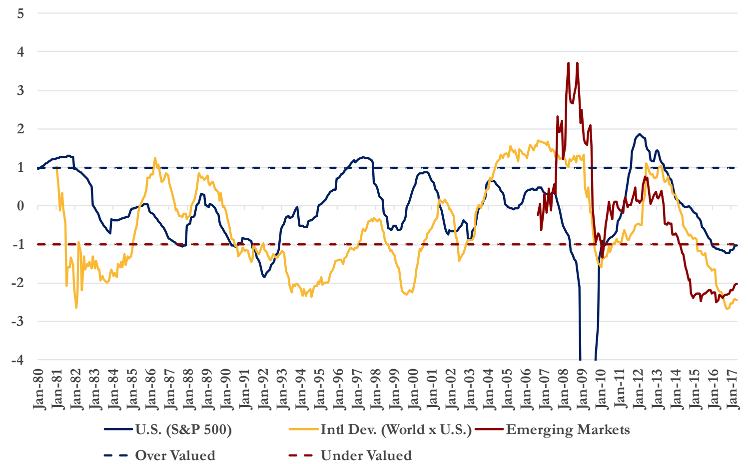
So how do we prepare, and how do we take advantage of opportunities? The topic of global equity allocation offers an excellent perspective into our process for data gathering, analysis, and decision-making. Specifically, our four primary capital market inputs include 1) **Fundamentals**, 2) **Relative Value**, 3) **Economic Regime**, and 4) **Momentum**. In this *Insight*, we will focus primarily on how we use fundamental analysis to deliver superior risk-adjusted returns in global equities.

FUNDAMENTALS: EARNINGS GROWTH

Fundamentals relate to the underlying drivers of return – including earnings growth, valuations, dividend yields, and currency effects – that ultimately inform our long-term expected return and risk forecasts for different equity markets. Empirical evidence indicates that long-term equity returns are predominantly influenced by these variables. In Highland's capital markets analysis, we look at each of these return drivers in multiple contexts. We compare these metrics to their history, seeking to identify historical extremes or evidence of a change in direction or trend. We also compare these metrics across regions, seeking to determine if relative differentials could increase the probability that one region might outperform or underperform another.

Figure 1 conveys the uncomfortable reality that earnings growth in recent years falls well short of its long-term average. For U.S. equities (indicated by the blue line), trailing 10-year earnings are a full standard deviation below their historical average. This is due largely to the devastating effects of the Global Financial Crisis and the historically weak recovery that followed. Most recently, U.S. earnings growth stagnated for two years as the market absorbed large losses in the energy sector following a massive peak-to-trough decline in oil prices. Importantly, international developed and emerging market earnings (indicated by the yellow and red lines, respectively) look even weaker relative to their own history, as both regions' trailing 10-year earnings are more than two standard deviations below average. Earnings in international developed markets, including Europe and Japan, have languished due to government-enforced austerity measures and poorly functioning credit markets. In emerging markets, historically weak currencies have hurt overall earnings growth broadly, while China has struggled with its transition from the "old economy" driven by infrastructure to the "new economy" driven by a rising middle class and consumer spending power.

FIGURE 1



SOURCE: SHILLER; S&P; BUREAU OF LABOR STATISTICS; MSCI; FACTSET; HIGHLAND ASSOCIATES

While all regions have exhibited weakness over the past decade, U.S. corporate earnings have grown faster due largely to significant cost-cutting initiatives, merger and acquisition activity, and share repurchases. As a result, U.S. corporate profit margins currently stand near historic highs. Future profit margin expansion is unlikely to be meaningful, and material margin contraction is certainly within the realm of possibility. U.S. companies will have to generate meaningful revenue growth to drive earnings higher going forward. With aggregate demand still weak due to demographic challenges and slow productivity gains, generating sales growth will be challenging for many companies and industries.

Non-U.S. equities may have higher earnings growth potential going forward. While European and Japanese equities face similar challenges to the U.S. in terms of demographics and productivity, they are not operating anywhere near peak capacity. Profit margins in many international regions remain at the trough levels achieved during the financial crisis, and the gap between European and U.S. profit margins currently stands at record highs. While international profits are not guaranteed to mean revert higher, there appear to be several catalysts in place. First, Europe is well positioned to benefit from accelerating global growth, given its significant connections to both U.S. and Asian markets. Secondly, the European banking system is showing continued signs of strength, as lending activity accelerates and balance sheets are more resilient than at any time in the past decade. According to data from Bloomberg and J.P. Morgan, aggregate earnings for

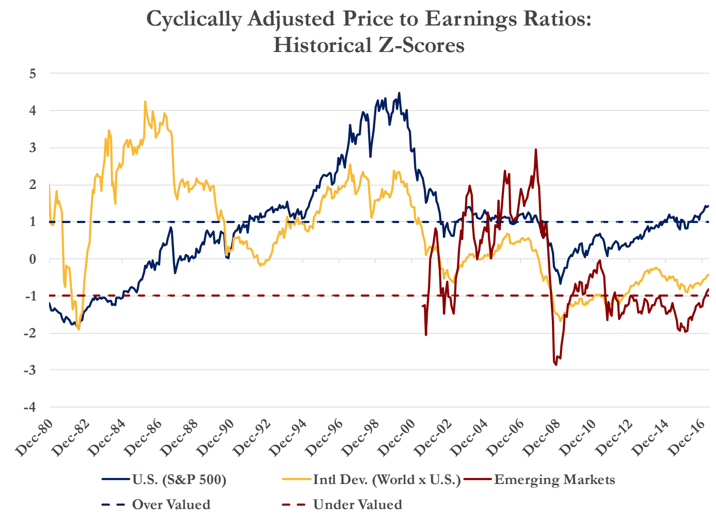
European stocks (using the Stoxx 600 Index as a proxy) grew by over 23% in the first quarter, and expectations for future growth continue to accelerate. Finally, Japanese equities (using the Topix Index as a proxy) reported aggregate earnings growth of 28% in the most recent quarter. Recent strength in Japan is largely the result of a renewed focus on corporate governance and capital allocation, as Japanese executives have pledged to increase returns on equity and overall returns to shareholders.

Emerging markets are distinguished from the U.S. and international developed markets in that demographics are likely to represent a powerful enhancement to future growth, rather than a drag. The growing middle class in China and India could drive extraordinary growth, as more than one billion individuals in these countries are expected to emerge from poverty in the next decade. Corporate earnings in emerging markets have also shown a nice recovery recently, and the gap in emerging markets earnings growth relative to U.S. earnings growth appears to be widening. Currently, the Institutional Brokers' Estimate System ("IBES"), a service that aggregates analysts' published estimates, indicates that earnings will grow by 20% in emerging markets in 2017, versus just 10% for the U.S. This could be a very sustainable catalyst for emerging market equities.

FUNDAMENTALS: VALUATION

Current valuation levels also tend to favor non-U.S. equities over U.S. stocks. ***Figure 2*** illustrates that valuations for U.S. equities (indicated by the blue line) are expensive relative to their own history, as well as their international developed and emerging markets counterparts. The current cyclically adjusted price-to-earnings ratio for U.S. stocks is well over one standard deviation above average. However, valuations for international developed and emerging market equities (indicated by the yellow and red lines, respectively) are well below their historical averages.

FIGURE 2



SOURCES: SILLER; S&P; BUREAU OF LABOR STATISTICS; MSCI; FACTSET; HIGHLAND ASSOCIATES

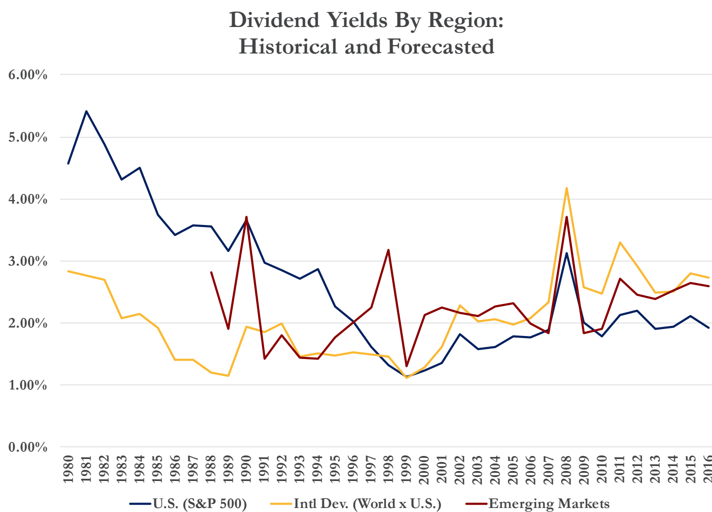
Higher price multiples on the U.S. stock market relative to international markets is a function of several factors, including superior U.S. earnings growth in the post-financial crisis era. While European economies and companies struggled with the constraints of austerity measures, U.S. companies did not have to navigate such onerous fiscal constraints. In addition, the safe haven status of the U.S. has attracted significant foreign investment capital seeking stability, and this strong demand has clearly bid up the price of U.S. equities. In total, more than $23 trillion in foreign capital has been invested in U.S. financial instruments in the years following the Global Financial Crisis, with equities a prime beneficiary of this capital influx. Of course, the U.S. Federal Reserve's steadfast commitment to historically accommodative monetary policy has also played a huge role in supporting higher equity prices.

Higher current valuations for U.S. equities may be justified on a backward-looking basis, but investors should focus on the future. U.S. equity valuations are in truly rarified air, and investors must understand that U.S. stocks are much closer to being priced to perfection than to disaster. Meanwhile, non-U.S. markets offer stronger downside protection through their much more reasonable valuations. The potential earnings catalysts described earlier could also drive valuations higher, as improved investor sentiment translates to higher prices. All else being equal, higher valuations in the U.S. should signal weaker relative returns over the long-term.

FUNDAMENTALS: DIVIDEND YIELD

An analysis of dividend yields mildly favors non-U.S. equities over U.S. equities, although the argument is not as powerful as it is for earnings and valuations. For most of this century, overall yields on U.S. stocks (indicated by the blue line in ***Figure 3***) have been slightly below those of their developed international and emerging markets counterparts (indicated by the yellow and red lines, respectively in ***Figure 3***). As of year-end 2016, yields on international developed and emerging markets exceeded the yield on the S&P 500 by roughly 80 basis points and 70 basis points, respectively.

FIGURE 3



SOURCE: IMF; S7P; BUREAU OF LABOR STATISTICS; MSCI; FACTSET; HIGHLAND ASSOCIATES

This is primarily a function of the higher valuations awarded to U.S. stocks. Going forward, as we expect valuations outside of the U.S. to close the gap with the more richly valued U.S. market, we expect corresponding dividend yield differentials to diminish, as well.

FUNDAMENTALS: CURRENCY

Currency impacts are notoriously difficult to predict and generally have limited influence on our long-term expected return assumptions for domestic and international equities. For current context, the U.S. dollar has appreciated in recent years due to a variety of factors that may or may not sustain themselves going forward. These include an acceleration in overall economic growth relative to both international and emerging markets, as well as a move to less accommodative U.S. monetary policy relative to places like Europe and Japan. Looking forward, independent forecasts suggest that economic growth in Europe, Japan, and emerging markets is likely to accelerate, which could limit further upside potential for the U.S. dollar. Relatedly, improving economic conditions could compel foreign central banks to employ more restrictive monetary policy through interest rate hikes; to the extent that such changes occur, further dollar strength is likely to be limited.

We can look to the past to understand relationships between exchange rates and equity market returns, even if the future trajectory of currencies is uncertain. Empirical data indicate a strong relationship between movements in emerging market currencies and subsequent emerging market equity performance relative to developed equity markets. An appreciating dollar relative to emerging market currencies creates significant short-term pain for emerging markets, as weakening fundamentals are exacerbated by capital flight. However, this also tends to set up strong returns a few years later. Emerging market currencies dramatically declined beginning in 2013 and recently traded near their lowest level in decades. Earlier last year, emerging market currencies traded roughly 25% below the trough levels reached in early 2009 at the height of the Global Financial Crisis and roughly 20% below 2002 trough levels associated with the South American debt crisis. These currencies are priced for a crisis that is by no means certain to come. If historical patterns persist, weakness in emerging market currencies should soon (if it has not already) pave the way for strong relative performance for emerging market equities.

OTHER INPUTS: RELATIVE VALUE, ECONOMIC REGIME, AND MOMENTUM

The primary outputs of Highland's fundamental analysis are long-term forecasts for returns and the risks associated with those returns. It is important to note that we do not expect these forecasts to be perfectly precise, nor are they the only input in our asset allocation process. We also rely on **Relative Value**, **Economic Regime**, and **Momentum** analysis. Our **Relative Value** framework is an extension of our **Fundamental Analysis** and is used to inform overall portfolio construction and allocation decisions. Specifically, we carefully consider the forecasted risk and returns and the role of each asset class to determine rankings for overall asset classes (i.e., Public Equities, Fixed Income, Alternatives, Inflation-Sensitive, etc.) and segments within each

asset class. In the context of global equity allocation, the emphasis is on ranking U.S., developed international, and emerging markets equities to determine overall conviction, rather than relying solely on forecasted risk and return.

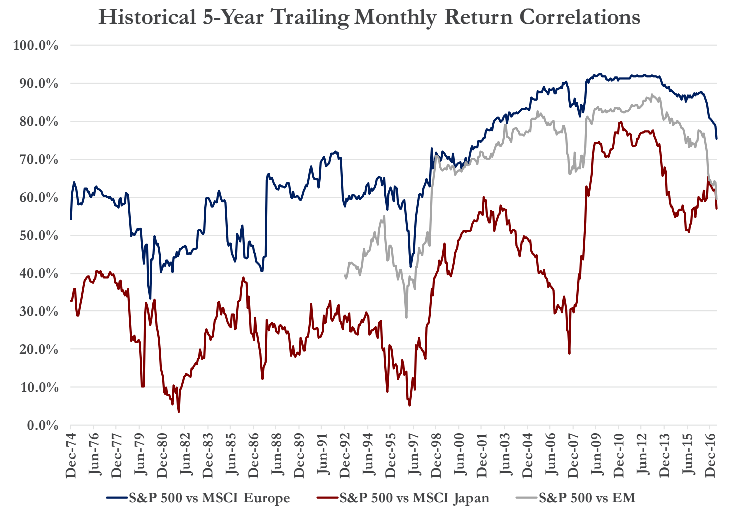
Our **Economic Regime** analysis considers the current state of the global economy and its impact on various asset classes. Today's environment is characterized by modest inflation and modest growth, although there are signs that both metrics could be accelerating both inside and outside of the U.S. Such an environment tends to support equities. At a more granular level, investors continue to anticipate meaningful regulatory and tax reforms in the U.S., although there is no guarantee that such market-friendly policies will be formally enacted. Outside of the U.S., there are clear signs that deflationary pressures in Europe and Japan have abated, while manufacturing activity in these regions continues to register multi-year highs. In emerging markets, the increasing spending power of the consumer class is helping to diversify these economies while driving strong overall growth.

Finally, our **Momentum** overlay stands in contrast to the other inputs for its emphasis on a more near-term picture, providing an appropriate balance to our long-term view. As it relates to global equity allocation, our momentum analysis examines the relative price strength of each region (U.S., developing international, and emerging) to determine conviction in our short-term outlook. To the extent that one region indicates significant positive or negative price momentum, we may tactically overweight or underweight that region until a change in relative strength trend is identified. Currently, all three regions are exhibiting strong price momentum, and thus we recommend a neutral weight for each region.

PORTFOLIO IMPLICATIONS

A large part of the appeal of investing outside of the U.S. stems from the expected diversification benefits. Historically, correlations between U.S. equities and various regions of the world have mostly ranged from 30%-70%, although there has been a noticeable uptrend in the last 20 years.

FIGURE 4



SOURCE: EVESTMENT; HIGHLAND ASSOCIATES

Figure 4 illustrates the uptrend began in the 1990s with the diminishing importance of Japan, as mounting debt and tepid economic growth reduced the nation's influence in both the global economy and capital markets. Higher correlation levels have persisted over the last two decades amid a massive overall shift toward globalization. With the Global Financial Crisis, correlations spiked to historic highs and generally held these levels until quite recently. Going forward, it is reasonable to assume that correlations will run at higher average levels than in the past, although investors may see some relief as fundamentals replace macro events as the drivers of returns.

Even if investors cannot count on correlation to drive diversification going forward, there are other market dynamics that should continue to support the case for global equity investment. As discussed in ***Part I*** of this *Insight*, the size of the investment opportunity set is strongly correlated to the probability of outperformance. Investors who focus strictly on U.S. stocks will limit themselves to an investable universe of fewer than 5,000 stocks in the most efficient market in the world. There are currently more dollars seeking fewer U.S. stocks than at any point in history, and it stands to reason that delivering alpha in such an environment will be difficult. However, those with the foresight to look beyond their borders will have well over 30,000 stocks from which to choose, thousands of which are underfollowed or misunderstood. It is intuitive that this should materially increase the likelihood of generating meaningful alpha, and performance data confirms it. U.S. large cap managers who

operate in strongly efficient markets have on average posted minimal excess returns throughout history, while international large cap, international small cap, and emerging market equity managers have on average delivered meaningful alpha relative to their broader benchmarks.

CONCLUSION

Sound investing is, among other things, an exercise in preparation. Successful investors must challenge themselves to discover what is not broadly understood and stand ready to act when opportunities arise. In the context of global equity allocation, there are several factors to consider. Fundamentally, non-U.S. equities trade at much more attractive valuations than their U.S. counterparts, which could eventually set the stage for a relative performance recovery. Higher growth potential and favorable demographics in emerging markets also support the case for investing outside of our borders. In addition, the vast opportunity set of stocks outside the U.S. should limit the efficiency of those markets, while also increasing the probability of generating meaningful alpha. For Highland's part, we will continue to monitor the data and maintain an open mind about the future. We will be prepared. Or, as they say in France, *toujours prête*!

IMPORTANT DISCLOSURES: The information provided herein is for informational purposes only. While Highland has tried to provide accurate and timely information, there may be inadvertent technical or factual inaccuracies or typographical errors for which we apologize. The information provided herein does not constitute a solicitation or offer by Highland to buy or sell any securities or other financial instrument, or to provide investment advice or service. Nothing contained herein should be construed as investment advice or a recommendation to purchase or sell a particular security. Investing involves a high degree of risk, and all investors should carefully consider their investment objective and the suitability of any investments. Past performance is not indicative of future results. Investments are subject to loss.

AUTHOR:

WILLIAM WYKLE, CFA
VICE PRESIDENT

HIGHLAND

HIGHLAND ASSOCIATES
2545 HIGHLAND AVENUE SOUTH, SUITE 200
BIRMINGHAM, ALABAMA 35205
P. 1-800-405-7729 OR (205) 933-8664 F. (205) 933-7688