# Bradley, Foster & Sargent, Inc.
## Quarterly Market Commentary

April 2019

### Is Now the Right Time to Buy International Equities?

"At Yale there were hundreds of boys from wealthy families, but not a single one who was investing outside the U.S. I thought that was just not sensible. Surely they'd get better results if they searched everywhere rather than limiting their search to one country."

John Templeton as quoted in *Investing the Templeton Way,* 2008

It has been difficult to make money in the international equity markets over the past eleven years. The U.S. stock market has more than doubled since January 1, 2008 — the year of the great Financial Panic, which originated in the U.S. but had devastating effects throughout the world. Conversely, the total returns for international equities have been dismal for the past decade and more. The MSCI EAFE Index had a cumulative total return (including dividends) of just 11.26% for the eleven-year period from January 1, 2008 through December 31, 2018. This index encompasses stock market returns from a basket of non-U.S. developed nations in Europe (including the U.K., Germany, France and Switzerland), Australia, Japan, and other developed nations in the Far East (hence the acronym EAFE). The equities in the emerging markets performed even worse. The iShares MSCI Emerging Market Index (EEM) had a negative cumulative total return of -2.76% for this period. This index encompasses 24 emerging nations including the BRIC nations (Brazil, Russia, India and China). China and Taiwan account for almost 40% of the index weighting. Meanwhile, the total return of the S&P 500 Index was up 115.94%. The chart below tells the story:

**U.S. Equities vs. International Equities**
**1/1/2008 – 12/31/18**


Source: Bloomberg

## Why Even Invest in International Equities?

Faced with this bleak performance of international equities over the past decade, an investor domiciled in the U.S. might well ask: Why bother to invest in foreign markets? Why not stick to the U.S.? Perhaps the best way to answer this question is to review the life of John Templeton — one of the greatest investors of the 20th century. He was also one of the earliest investment professionals to invest outside the U.S., and with great success.

Templeton was born in 1912 in Tennessee and grew up in humble circumstances. Taught by his parents the importance of hard work, thrift, and an optimistic approach to life, Templeton was admitted to Yale just as the Great Depression began. As he started his sophomore year, his father told him that he could not contribute anything to his education, but Templeton returned to Yale anyway, determined to find ways to raise the money to finish his education there. Through jobs, some financial aid, and great success at the poker table, Templeton graduated from Yale.

After completing a Rhodes scholarship year at Oxford University in England, Templeton and a friend undertook an around-the-world journey which included stops in Nazi Germany, India, China, and Japan. Templeton carefully studied the countries which he visited and learned their history and culture. This was the background of one of the great international investors. He thought it was shortsighted and arrogant to believe that the only good investment bargains were in the U.S.

Templeton's journey through Germany and Japan in the late 1930s convinced him that war was coming. Analyzing historical precedent in the Civil War and World War I, and believing that the U.S. was the arsenal for democracy, Templeton thought the war would revive U.S. industry from the depths it reached during the Great Depression. Accordingly, in 1939, two years before the U.S. entered the war, he borrowed $10,000 and, as a value investor, bought shares in all 104 stocks on the U.S. stock exchanges trading for less than $1. This included 37 bankrupt companies. Even at this young age, he believed in the importance of diversification. His bet paid off wonderfully. His original investment of $10,000 turned into $40,000 four years later. Only four of his purchases did not work out.

In 1954, Templeton launched the Templeton Growth Fund in Canada. From the outset, it was a global investment vehicle. It was his core belief that the fund should seek to invest in bargains wherever he found them throughout the world. But this did not mean spreading the assets in his mutual fund into stocks in 20 or 25 countries throughout the world. Instead, Templeton took a rifle shot approach by focusing on stocks in attractive companies in a limited number of countries — the so-called "bottom-up" approach. For him, getting a country right started with finding bargains in that country rather than analyzing a country's GDP, debt, and outlook for employment and then allocating money to that country.

However, before investing in stocks in any country, Templeton would ensure that the country in question had a free market economy, or that at least it was trending toward capitalism rather than socialism. It was also important that a country have a stable or strong currency; so analyzing the macroeconomic data which influenced currency was critical as well. He also favored countries with a low debt/GDP ratio.

His first major foray into Asia was in Japan. He was attracted to quality companies with P/E ratios of 10 or less, whose earnings were growing at 20 percent or more. In the 1960s, there was much less investment focus and research on foreign markets, which led to inefficient pricing. So there were amazing bargains available there. Moreover, Japan's GDP in the 1960s averaged 10.5% annually, and with extremely strong exports, its currency was appreciating against the U.S. dollar. Finally, his travels there convinced him that the Japanese were a frugal people with a very high savings rate and a strong work ethic. Consequently, the Templeton Growth Fund invested heavily in Japan in the 1960s and made a killing.

Decades later, Templeton used the same basic playbook to invest in the South Korea stock market, following the 1997 Asian economic crisis. In this case, he invested in the Matthews Korea Fund, as buying individual Korean stocks was problematic due to South Korean regulations restricting foreign investors. In less than two years, the Matthews fund was up 267%. Thus, Templeton was able to show superb investment performance once again using this approach.

## Modern Portfolio Theory

Modern Portfolio Theory (MPT) was developed by Nobel Laureate Harry Markowitz in 1952 and has been refined by other economists over the years. Our purpose in this commentary is not to delve deeply into MPT theory and mathematics but to summarize briefly its main tenets with particular emphasis on how it affects investing in international equities. The goal of investors is to maximize returns, while at the same time minimizing risk. In essence, MPT suggests that an investor can limit the volatility (risk) in a portfolio while improving its performance by spreading risk among different types of securities that are not closely correlated. MPT emphasizes the importance of diversification in a portfolio among asset classes that are not correlated. The asset classes that can be used to lower risk are cash reserves, TIPs, and fixed income instruments, but these asset classes have generally had lower returns than equities over the longer term. U.S. equities typically have had higher returns than bonds, but greater volatility. International equities for certain discrete periods have had even greater returns than U.S. equities, but also expose portfolios to greater risk.

Because many of the principles of MPT have been broadly embraced by the investment community, many, perhaps the majority, of investment advisors routinely counsel their clients to invest a portion of their assets in international equities. They often recommend allocating twenty percent or more of a client's portfolio to equities in developed countries. In executing this strategy, most registered investment advisors (RIAs) do not buy individual securities in these markets, but rather purchase mutual funds and exchange traded funds (ETFs) which invest broadly in most of the stock markets represented in the MSCI EAFE Index, which is used as the performance benchmark. This is a very different approach than the rifle shot methodology which John Templeton used. Moreover, the same RIAs often advocate investing ten percent or more of a client's portfolio in emerging markets using mutual funds and passive index funds to invest in these stock markets.

### Broad Diversification but Close Correlation to U.S. Stock Market

There are two major problems with this approach. The first is that the use of international equity markets to minimize risk and increase performance depends on the premise that the international equity markets have a low correlation to the U.S. stock market. In other words, MPT assumes that when the U.S. stock market experiences a bear market, equities in foreign markets will perform positively or not as poorly as in the U.S. However, the empirical data over the past two decades demonstrates that the exact opposite has occurred; the markets are in fact highly correlated. The table below shows the performance of the S&P 500 Index and the MSCI EAFE Index in the last two major bear markets (also the EEM ETF in the most recent bear market):

**Investment Performance (Peak to Trough)**
**Two Most Recent Bear Markets**

| | 2001-2003 | 2007-2009 |
|---|---|---|
| **S&P 500 Index** | **-33%** | **-58%** |
| **MSCI EAFE Index** | **-34%** | **-64%** |
| **iShares MSCI Emerging Markets ETF** | **N/A** | **-67%** |

Source: Bloomberg

The second issue has to do with the poor economic performance of many countries in the MSCI EAFE Index. The compound annual growth rate of Japan, which has the largest GDP of any country in the index, was only .76% for the 11-year period from 2007 through 2017. The GDP for Italy during this period shrank by more than 10%. The compound annual growth for the European Union for the same period was less than 1%. It is difficult for a stock market in a country to turn in strong returns over time when there is little economic growth in the country. Investing in passive index funds and ETFs which allocate money across stock markets in countries with slow economic growth is not a winning strategy.

On the other hand, the U.S. has achieved substantially better economic performance than most of the countries in the MSCI EAFE Index for this period. This has been reflected in the performance of the U.S. stock market. Over the past 19 years, the cumulative returns of the S&P 500 Index are almost double that of the MSCI EAFE Index, as the following table shows:

**Investment Performance**
**2000-2018**

| | Compound Annual Growth Rate | Cumulative Returns |
|---|---|---|
| **S&P 500 Index (total return)** | **4.86%** | **146.5%** |
| **MSCI EAFE Index (total return)** | **2.96%** | **74.2%** |

Source: Bloomberg

### Is Now the Time to Invest in International Equities?

At the moment, international stock markets appear to be cheap compared to the U.S. stock market. The S&P 500 Index is currently trading at a P/E of 16.5 on 2019 estimated operating earnings. The P/E ratio for the MSCI EAFE Index on 2019 earnings is 13.7, and its dividend yield is 50% higher than the 2% yield for the S&P 500 Index. The P/E ratio on 2019 operating earnings of the MSCI Emerging Market Index is even lower at 12.7.

These international stock markets are cheaper than the U.S. stock market, but that does not necessarily mean it is a good time to dive into the international markets with a Modern Portfolio Theory approach. Europe has serious economic and political problems. The populist and nationalist uprising in various countries, weak government leadership, high debt/GDP ratios, and slow economic growth seem to account for the low stock market valuation. Europe may well be a value trap.

Japan has not only a very high debt/GDP but also a serious demographic problem with a shrinking population, which has resulted in its anemic GDP growth rate over the past decade. Meanwhile, Greater China (China, Hong Kong and Taiwan) represents more than 40% of the iShares MSCI Emerging Markets Index (EEM) weighting, and the current economic slowdown in China, combined with a possible trade war with the U.S., leads one to approach investing in the EEM with caution at the moment.

At Bradley, Foster & Sargent, we are generally not advocates of automatically allocating a large percentage of client portfolios into international equity ETFs and passive indexes. Some institutional clients or others may prefer the MPT approach, but it has not worked well since the Great Recession in 2008. Portfolios with 20-30% of assets invested in broadly diversified international equity ETFs and passive international index funds investing in stocks in 20 or more countries have underperformed the S&P 500 Index, as the chart on the first page demonstrates.

At BFS, we approach investing in international markets in two ways. Firstly, our largest equity positions in client portfolios are in quality U.S. large cap companies, many of which have 50% of more of their revenues and earnings coming from outside the U.S. These include companies in the information technology, social media, energy, industrials, medical, and consumer staples sectors. So these portfolios are benefiting from stocks in companies which are deriving much of their sales and earnings from participation in the global economy. Secondly, we generally follow the Templeton investment methodology. We look for equities in great companies with excellent brands, strong balance sheets, good management, and robust cash flow at attractive prices anywhere in the world. Most of the international stocks in client portfolios are in companies domiciled in the E.U., Switzerland, and various countries in Asia. In summary, we believe that some of the world's greatest companies are in foreign lands, but we generally prefer to invest in them one-by-one to achieve superior investment performance.

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*Investment Management*

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