Insights on Investing

Manager Q & A:

International Investing—Why Now?

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Geoff Sulanke is Davenport's Director of Manager Research and is responsible for asset allocation decisions and selecting investment managers for the firm. He has been with Davenport & Company for 13 years, with 8 years in his current role. See below for his current thoughts on the international markets.

Q Why is now the right time to invest abroad?

A If stronger economic growth expected in the U.S. can materialize, the rest of the world—particularly the emerging markets—should be along for the ride. There are four things that make us hopeful about investing in the international markets:

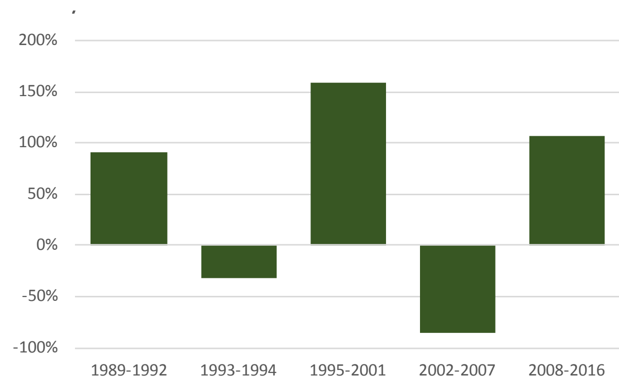
1. International markets have been out of favor for longer than normal;
2. Stock valuations overseas appear more attractive;
3. Economic growth seems to have stabilized; and
4. Investor sentiment toward international stocks is improving.

Q Can you give some historical perspective on the performance of international and domestic stock markets?

A There is a cyclical relationship to the returns of international and domestic markets as displayed in the chart below. For instance, over the past 15 years the returns have been similar but that has included two very distinct periods. From 2002-2007 the international market returns, as represented by the MSCI All Country World ex USA Index (MSCI ACWI ex USA) that includes developed and emerging markets, led the S&P 500 Index by 85% cumulatively. Since 2008, it was reversed with the S&P 500 gaining 97%, while the international market declined 0.8%. We believe we are approaching the end of this cycle, and that international markets may be poised to once again outperform domestic markets.

Cyclical Stock Returns of International vs. U.S.[1]

Return of the MSCI ACWI Ex USA Index Minus
Return of the S&P 500 Index From 1989-2016



Q Can you elaborate on stock market valuations in international markets?

A Overseas price-to-earnings (P/E) multiples are below those in the U.S. and are closer to their long-term averages. According to Bloomberg, the P/E on the S&P 500 is currently 18.2x versus 12.5x for the emerging markets. We have also had earnings in the US continuing to rise and hit all-time records while international market corporate earnings have been declining since 2011. If that trend were to reverse, international stocks would appear significantly "cheaper" than US stocks and could post better returns. One factor that may have begun to contribute to better earnings abroad is a stronger dollar. (See chart on following page.)

Q Will higher interest rates continue to make the dollar stronger?

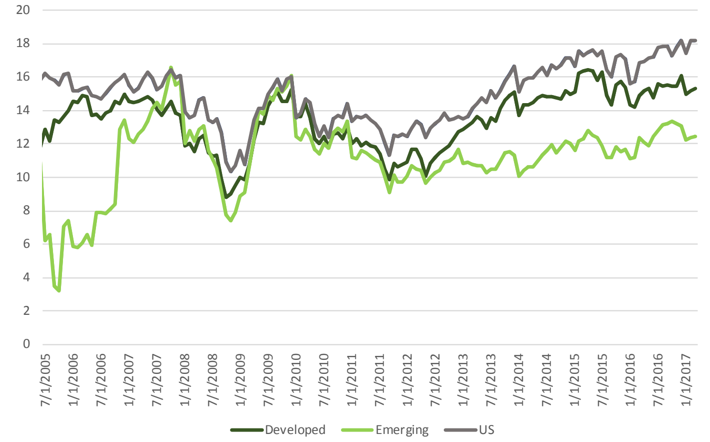
A Theoretically, yes. The dollar has already gained a lot of ground versus some of the larger currencies around the globe, like the Euro and the Yen, so much of the anticipation of higher interest rates may be priced in. The dollar may continue to strengthen; however, we believe it will likely be at a slower pace than in the last few years.

[1]Source Morningstar Direct. Data from 1/1/1998-12/31/16. ***The MSCI ACWI ex USA Index*** captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries (excluding the U.S.) and 23 Emerging Markets (EM) countries. With 1,853 constituents, the index covers approximately 85% of the global equity opportunity set outside the U.S. The **S&P 500 Index** is comprised of 500 U.S. stocks and is an indicator of the performance of the overall U.S. stock market. An investor cannot invest in an index and index returns are not indicative of the performance of any specific investment.

Q In recent years, some investors have questioned the diversification benefit of international investments. Can you comment on that?

A I once heard someone say that as soon as you have two investments, you hate one of them. That has certainly been the case for anyone that has invested in international markets recently. Given their lackluster performance, it is not surprising that some investors see this as justification for not owning international stocks. There is no question that some of the diversification benefit of international investing (i.e. low correlation) has declined as globalization has increased and economies have become more dependent on one another for growth. This may mean they have more tendency to move in the same direction, but there is very obviously a difference in the magnitude of the returns and the timing of when one will outperform the other. I would remind them, however, that in the middle part of last decade, there were countless articles written about the slow death of the U.S. economy and the inevitable end of its reign as the strongest, most stable economy in the world. What proceeded was 10+ years of U.S. economic and market dominance over other areas.

Historical Valuations International vs. U.S.[2]



Q Where do you think the best opportunities lie?

A We think emerging markets probably provide better return opportunity but also the most potential volatility. Slowing growth in China, President Trump's nationalistic rhetoric, and terrorism threats have weighed on returns over the past several years, creating an opportunity for long term investors. After a five year period of negative returns, many emerging market stocks now have much cheaper valuations than other areas of the world and companies have depressed earnings that could be poised to rebound. Additionally, many of the emerging market countries have higher economic growth rates than the rest of the world. These are vibrant economies with lots of wealth being created that leads to stronger growth. The middle class is growing at a rapid pace, driving significant increases in consumption. In fact, emerging markets consumption is estimated to be more than half of the world's by 2025 (according to MSCI) and their economies currently make up nearly 40% of global GDP (according to the CIA's "World Factbook").

Q What percentage of one's portfolio would you allocate to international markets?

A This is a difficult question to answer since every client's risk tolerance and objective is different. For those that it is appropriate, we think that a 10-15% allocation is enough to make a meaningful contribution to returns. The timing of this type of shift in allocation can be a challenge so we generally try to make it a process rather than an event, building the allocation over some period of time. Two things to consider are the higher potential volatility of international stocks and the fact that many large multi-national companies in the U.S. are giving you some exposure to these markets.

Q Are there any final thoughts you would like to add?

A Long-term stock returns should be similar in the domestic and international markets, but there can be wide swings over shorter time that provide good entry points. Now may be one of those times. Investors that have owned international stocks certainly should not give up on them now, and those that haven't may find some good bargains.

As of April 14, 2017

[2]Source Bloomberg. Data from 5/1/2005-3/31/2017. Developed represented by the **MSCI All Capital World ex USA Index (MSCI ACWI ex USA),** which captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries (excluding the U.S.) and 23 Emerging Markets (EM) countries. With 1,853 constituents, the index covers approximately 85% of the global equity opportunity set outside the U.S. Emerging represented by **MSCI Emerging Markets Index,** a capitalization-weighted index of stocks from 26 emerging markets that only includes issues that may be traded by foreign investors. The reported returns reflect equities priced in US dollars and do not include the effects of reinvested dividends. U.S. represented by the **S&P 500 Index,** which is comprised of 500 U.S. stocks and is an indicator of the performance of the overall U.S. stock market.