Global Perspectives, March 2019: How to Beat the (Foreign) Market

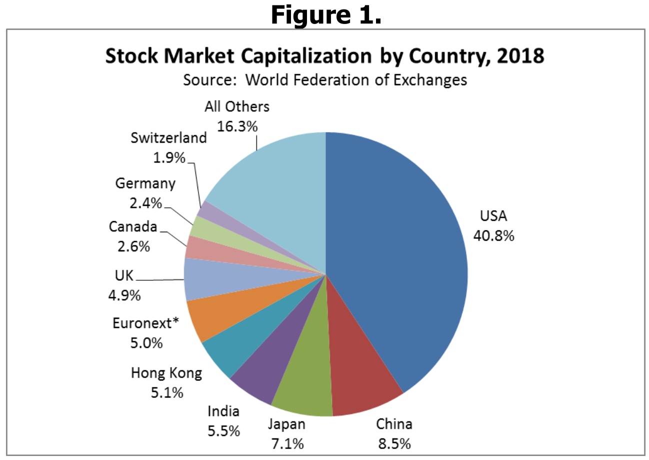
Academic research shows one of the best ways to reduce investment risk is to keep a portfolio broadly diversified. That way, if one asset or asset class loses value, there's a chance the drop will be offset by good gains in some other asset or asset class. However, many U.S. investors who spread their stock portfolios across multiple foreign countries have been frustrated by the negative impact on their returns. Lured by the logical idea that innovative, growing companies exist all over the world, many investors hoped to receive both the good returns historically provided by equities and the risk-reducing benefits of diversification, but the returns on foreign stocks as a whole have seriously lagged U.S. stock returns for much of the last decade. To better understand why, and perhaps find a better way to diversify internationally, we recently conducted a study on the relative performance of foreign stocks by country.

Overview of the World's Stock Markets

To set the stage for the discussion, it's important to have some understanding of the size of the world's various stock markets. Typically, the size of a stock market is measured by its total market capitalization, i.e., the total value of the stocks traded there. Data from the World Federation of Exchanges indicates global stock market capitalization at the end of 2018 stood at $74.7 trillion, with U.S. stocks alone accounting for $30.4 trillion, or 40.8% of the total (see Figure 1). The other top ten markets include developed nations such as Japan and the United Kingdom, as well as major "emerging markets" like China and India. The total range of stock markets is quite large. For instance, the "All Others" category in Figure 1 includes small markets in countries ranging from Nigeria to Sri Lanka and even Jamaica.

There is a school of thought that argues an investor's global stock allocation should mirror that of the global markets themselves, i.e., 40.8% in U.S. stocks, 8.5% in Chinese stocks, and so on. However, research shows that investors around the world tend to favor their own country, and that's what we ourselves do. We think there's something to be said for over-weighting the country that you're most familiar with. We think investors tend to sleep a bit better at night when they know their money is invested in the companies they see every day, and in the companies that are mostly regulated by a government they themselves elect. In our own strategies, we tend to keep the U.S. portion of our total stock exposure at about 75%. As discussed below, that's been a winning formula based on the relative performance of U.S. and non-U.S. stocks in recent years.

Figure 1.

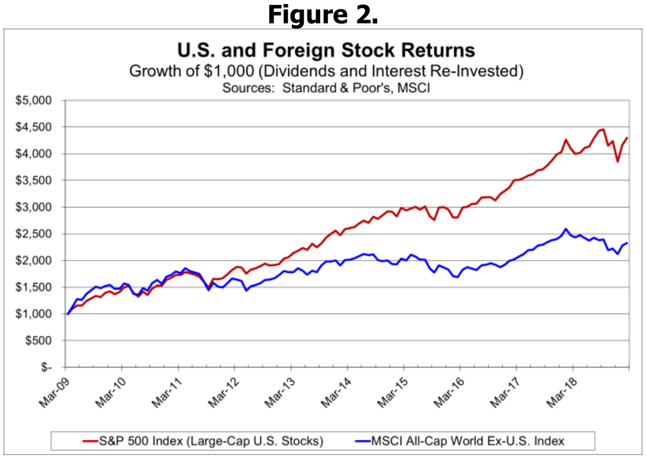


Leaders and Laggards

To make our study as meaningful as possible for U.S. investors, we focused on single-country investment funds available in the United States; we used broad, multi-country indexes only for high-level comparisons. We especially wanted to examine the relative performance of exchange-traded funds (ETFs) like those we use in our own portfolios and that many U.S.-based individual investors trade on their own. In an effort to ensure the various ETFs were as comparable as possible, we also wanted to focus on funds from the same company. Fortunately, the "iShares" ETFs offered by Blackrock fit that description nicely. We considered more than 35 iShares ETFs that: a) track a single country's large-cap or all-cap stock market index; b) are not hedged against currency fluctuations; and c) have a performance history stretching back approximately seven years.

The seven-year history is important for a couple of reasons. First, requiring a longer history would severely limit the number of ETFs we could study, while a shorter history might not reflect each country's long-run performance. Another consideration was how the world's stock markets have performed since the Great Recession and worldwide bear market of 2008-2009. As shown in Figure 2, U.S. and foreign stocks moved pretty much in tandem from the nadir of the bear market in March 2009 until late 2011. Only then did U.S. stocks keep rising relentlessly as foreign stocks nearly stagnated. Looking only at the period from the end of February 2012 to the end of February 2019 therefore allowed us to focus on the relative performances only while foreign stocks as a whole were lagging. The question we wanted to get at was whether particular countries were responsible for the weak overall performance of foreign stocks since late 2011. Did some countries' stocks perform on par with U.S. stocks? Did some single-country ETFs perform even worse than overall foreign stocks?

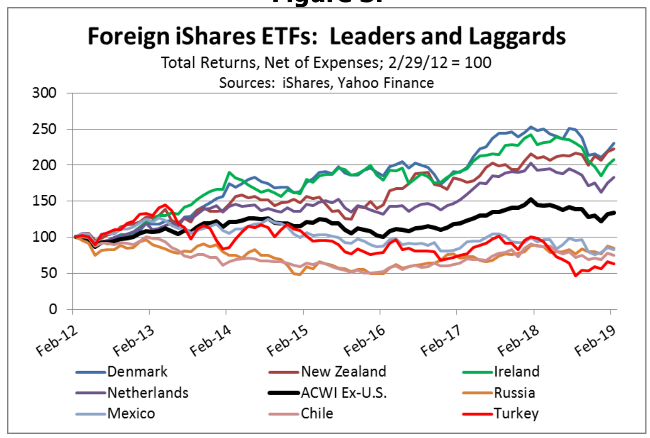
Figure 2.



Of the single-country iShares ETFs in our study, our analysis shows a U.S. investor would have gotten his or her best returns from the iShares MSCI Denmark ETF. That fund produced an average total return of 12.71% per year since 2012, almost matching the return of 13.00% for the U.S.-focused iShares Core S&P 500 ETF over the same period. The second-best returns came from the iShares MSCI New Zealand ETF, which produced an average return of 12.02%. The third-best performer in our study was the iShares MSCI Ireland ETF, with an average return of 11.01%, while the fourth-best performer was the iShares MSCI Netherlands ETF, with an average return of 9.11%. None of these funds beat the S&P 500 ETF, but their returns were all several times better than the broad, multi-country index funds. Over the study period, the iShares MSCI All-Cap World Index Ex-U.S. ETF had an average annual return of just 4.34%.

At the other end of the spectrum, several funds seriously underperformed even the broad foreign indexes. Worst of all was the iShares MSCI Turkey ETF. It was a true turkey, with an average annual loss of 6.35% since 2012! Only slightly better were the iShares MSCI Chile ETF, with an average loss of 3.95%, and the iShares MSCI Mexico ETF, with an average loss of 2.65%. The iShares MSCI Russia ETF lost 2.31% per year (see Figure 3 and, on the next page, Table 1).

Figure 3.



What's Behind These Performances?

Naturally, past performance doesn't necessarily show how an asset will perform in the future. Table 1 makes clear that some foreign ETFs that performed relatively well in one period faltered in the next, and vice versa. Nevertheless, the obvious question that arises from the discussion above is: Why did some ETFs outperform the broad international index, while others underperformed? And are the reasons behind their outperformance or underperformance likely to be repeated?

A country's stock market returns can theoretically be impacted by a wide range of factors, from demographics and economic growth to government regulation and political trends. There's no way to examine every possible factor here. All the same, we wanted to take a first cut at understanding some of the basic factors that could help determine the differing performances of international ETFs. The discussion is only meant to show some of the factors that might have an impact on foreign stock markets. Even when a factor seems to have an impact, we suspect it doesn't necessarily explain everything. The key factors that we examined were:

Economic Growth. Over the long run, we believe a country's economic growth is a key factor in how much profit it produces for the investors who own its capital. In the short run, our analysis indicates that changes in economic growth also tend to lead a country's bull markets and bear markets. Indeed, as shown at the bottom of Table 2 (last page), the four countries with the best performing ETFs in our study had modestly better economic growth than the worst performing countries. Over the seven years ended in 2018, GDP growth in the top performing countries averaged 3.33% per year, while growth in the lowest performing countries averaged 2.98%. That may not seem like a big difference, but we think it's significant since all the bottom performers are considered fast-growing emerging markets.

Demographics. Given the economic challenges already arising from slowing global population growth and population aging, one would also expect demographics to have an impact on foreign stock returns. However, our study suggests the relationship may be weaker than thought. Table 2 shows that over the last seven years, the countries with the top ETFs had average population growth of 0.89% per year, only slightly beating the 0.88% growth rate in the bottom performing countries.

Fund Concentration. One clear hallmark of both the outperforming and underperforming ETFs was that they are much more concentrated than the ETFs tracking the broad indexes. For instance, Table 2 shows the top three stocks in the All-Cap World Index Ex-U.S. ETF accounted for only 5.06% of the fund's holdings at the end of 2018. In contrast, in all the top and bottom performers, the top three holdings accounted for at least 24.20% of the fund. We think this suggests the outperformance of some foreign ETFs may have simply reflected the fact that the fund was dominated by a particularly successful company or two, while the worst performing ETFs might have simply had the misfortune of being dominated by a few companies that were especially weak.

Industry Exposure. Looking at global stock markets over the last seven years and more, it's clear that the highest total returns have tended to come from just three industries: information technology, healthcare, and consumer discretionary. That makes sense to us, since those industries seem especially well placed to grow their sales and profits in a world struggling against headwinds like globalization, population aging, income inequality, and high debt. In fact, the strong performance of U.S. stocks over the study period appears to have come mostly from the fact that those industries make up so much of the U.S. market. At year-end 2018, firms in the technology, healthcare, and consumer discretionary industries accounted for fully 45.53% of the S&P 500 ETF, but only 26.22% of the broad non-U.S. index fund. The top three industries accounted for 29.66% of the four best-performing foreign ETFs in our study, but only 5.17% of the four worst-performing funds. On the flip side, banking and other financial stocks have tended to be poor performers in the wake of the Global Financial Crisis, probably reflecting factors such as lingering bad loans and increased bank regulation. Importantly, financials accounted for only 19.83% of the four best-performing ETFs in our study period, while they made up 30.03% of the four worst performers.

Table 1.

iShares International ETFs: Total Returns Net of Expenses

Average Annual Returns (%, Mkt. Price), Periods Ended 2/28/19

Source: iShares

		Average Annual Total Returns (%)			
Country	**Symbol**	**1 Year**	**3 Years**	**5 Years**	**7 Years**
USA	**IVV**	**4.67**	**15.26**	**10.61**	**13.00**
Denmark	EDEN	(7.48)	7.22	5.62	**12.71**
New Zealand	ENZL	5.91	15.53	8.88	**12.02**
Ireland	EIRL	(8.92)	4.85	1.90	**11.01**
Netherlands	EWN	(5.04)	11.66	5.06	**9.11**
Belgium	EWK	(15.74)	5.61	3.17	**9.05**
Hong Kong	EWH	3.79	16.58	8.56	**8.46**
Finland	EFNL	(5.19)	12.31	4.70	**8.24**
Switzerland	EWL	1.54	9.51	2.63	**7.66**
France	EWQ	(4.90)	11.64	2.71	**6.85**
Israel	EIS	6.45	7.53	3.13	**6.34**
Japan	EWJ	(9.61)	9.33	4.73	**6.02**
China	MCHI	(11.01)	18.42	8.12	**5.95**
Thailand	THD	(8.56)	15.18	8.20	**5.84**
Taiwan	EWT	(6.53)	12.00	6.17	**5.60**
Austria	EWO	(17.47)	15.46	2.21	**5.33**
Germany	EWG	(13.82)	7.76	(0.87)	**4.74**
All-Cap Wld Ex-U.S.	**ACWX**	**(6.05)**	**10.71**	**2.42**	**4.34**
Sweden	EWD	(6.77)	7.31	(0.05)	**4.22**
India	INDA	(3.90)	11.92	7.11	**3.97**
Philippines	EPHE	(7.00)	1.41	0.28	**3.89**
Australia	EWA	(1.34)	12.39	1.67	**3.27**
United Kingdom	EWU	(1.72)	7.37	(0.73)	**3.25**
Brazil	EWZ	(2.45)	31.08	3.66	**3.14**
Italy	EWI	(10.89)	10.02	(1.19)	**3.05**
Spain	EWP	(8.35)	8.95	(2.52)	**2.92**
Singapore	EWS	(8.51)	10.67	2.21	**2.40**
South Korea	EWY	(11.50)	12.58	2.45	**2.32**
Canada	EWC	2.81	11.10	1.18	**1.53**
Poland	EPOL	(9.97)	12.29	(3.32)	**0.82**
Norway	ENOR	(3.12)	14.49	(1.45)	**0.68**
Peru	EPU	(6.30)	23.30	4.84	**0.06**
Indonesia	EIDO	(8.34)	5.86	1.64	**(0.78)**
South Africa	EZA	(22.04)	9.60	(0.07)	**(1.03)**
Malaysia	EWM	(9.29)	4.24	(3.64)	**(1.18)**
Russia	ERUS	(4.59)	19.12	2.50	**(2.31)**
Mexico	EWW	(10.92)	(1.59)	(4.53)	**(2.65)**
Chile	ECH	(14.19)	12.92	2.41	**(3.95)**
Turkey	TUR	(35.35)	(6.77)	(5.82)	**(6.35)**
Averages					
Top Four ETFs		(3.88)	9.82	5.37	11.21
Bottom Four ETFs		(16.26)	5.92	(1.36)	(3.82)

Conclusion

To reiterate: Past performance is not necessarily indicative of future performance. The top-performing foreign ETFs identified here may not necessarily produce the best returns going forward, and vice versa. Besides, it's important to remember that our study was quite limited. There are plenty of other issues that can have a bearing on performance, such as fluctuating foreign exchange rates (indeed, over the last five years, a currency-hedged iShares ETF tracking the broad MSCI EAFE international index outperformed its non-hedged version by 4.27%, though its returns were still much

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weaker than the S&P 500). All the same, we think a key lesson here is that investing in the ETFs of countries with better economic growth, expanding populations, and high exposure to the fastest-growing global industries may increase the odds of producing good returns over the long term, though their concentrated portfolios may make them relatively volatile and risky. Although we usually choose single-country ETFs based on their short-term momentum, we'll keep the lessons of this study in mind as we choose foreign ETFs going forward.

Patrick Fearon, CFA
Lead Portfolio Manager

Table 2

iShares International ETFs: Total Returns v. Economic/Financial Indicators

GDP and Population: Average Annual Growth Rates 2011-2018; Holdings and Industry Holdings at 12/31/18

Source: iShares

Country	Symbol	Ave. Total Return (%)	GDP Growth (%)	Population Growth (%)	Top 3 Holdings (%)	Allocations to: Technology (%)	Healthcare (%)	Cons. Disc. (%)	Financials (%)
USA	**IVV**	**13.00**	**2.30**	**0.72**	**10.04**	**20.09**	**15.52**	**9.92**	**13.35**
Denmark	EDEN	**12.71**	1.51	0.59	34.45	2.02	**40.61**	2.60	11.50
New Zealand	ENZL	**12.02**	3.19	1.70	30.13	0.57	**18.59**	8.25	0.00
Ireland	EIRL	**11.01**	7.19	0.87	45.39	0.20	4.55	13.08	10.26
Netherlands	EWN	**9.11**	1.43	0.42	38.72	20.57	6.53	1.05	17.20
Belgium	EWK	**9.05**	1.11	0.52	37.44	2.58	13.28	1.62	**26.03**
Hong Kong	EWH	**8.46**	2.81	0.71	32.83	0.00	0.00	0.00	**60.57**
Finland	EFNL	**8.24**	0.73	0.39	37.96	20.04	2.85	6.42	11.19
Switzerland	EWL	**7.66**	1.84	1.08	45.11	0.97	**30.68**	5.68	19.69
France	EWQ	**6.85**	1.13	0.45	22.02	3.77	8.07	17.49	11.12
Israel	EIS	**6.34**	3.33	1.94	34.64	**29.86**	13.84	0.66	24.97
Japan	EWJ	**6.02**	1.29	(0.16)	8.20	9.92	8.77	19.05	11.57
China	MCHI	**5.95**	7.15	0.52	33.18	2.50	2.84	19.95	23.22
Thailand	THD	**5.84**	3.66	0.32	24.67	1.69	5.09	5.41	18.69
Taiwan	EWT	**5.60**	2.30	0.23	31.34	**52.15**	0.27	4.42	19.39
Austria	EWO	**5.33**	1.41	0.82	41.48	2.02	0.00	1.66	**36.27**
Germany	EWG	**4.74**	1.64	0.44	24.25	12.45	11.76	**17.21**	15.53
All-Cap Wld Ex-U.S.	**ACWX**	**4.34**	**NA**	**NA**	**5.06**	**7.65**	**8.35**	**10.22**	**23.87**
Sweden	EWD	**4.22**	2.16	1.18	20.62	11.23	0.00	6.21	30.75
India	INDA	**3.97**	6.93	1.32	27.47	16.68	5.39	10.12	**23.70**
Philippines	EPHE	**3.89**	6.58	1.84	29.33	0.19	0.00	5.78	**28.53**
Australia	EWA	**3.27**	2.75	1.61	25.48	0.64	9.05	5.55	**38.19**
United Kingdom	EWU	**3.25**	1.94	0.70	20.00	0.75	9.93	6.01	**20.37**
Brazil	EWZ	**3.14**	0.09	0.83	30.12	0.93	0.90	6.83	**36.18**
Italy	EWI	**3.05**	(0.00)	0.19	40.23	0.00	1.81	12.21	**30.19**
Spain	EWP	**2.92**	1.28	(0.14)	37.87	4.57	2.90	4.00	**37.29**
Singapore	EWS	**2.40**	3.46	1.27	45.55	2.13	0.00	5.31	**48.65**
South Korea	EWY	**2.32**	2.87	0.49	27.78	**29.87**	6.68	11.57	13.57
Canada	EWC	**1.53**	2.08	1.13	20.89	4.44	0.90	4.18	**39.55**
Poland	EPOL	**0.82**	3.15	(0.03)	36.56	1.48	0.29	6.33	**44.42**
Norway	ENOR	**0.68**	1.83	1.07	39.24	1.73	0.18	1.09	21.75
Peru	EPU	**0.06**	4.01	1.10	43.18	0.00	0.00	2.62	30.89
Indonesia	EIDO	**(0.78)**	5.24	1.32	32.37	0.00	1.88	11.08	**37.67**
South Africa	EZA	**(1.03)**	1.49	1.55	33.97	0.00	3.17	5.18	**32.55**
Malaysia	EWM	**(1.18)**	5.15	1.59	31.03	0.00	6.04	4.51	**34.80**
Russia	ERUS	**(2.31)**	0.95	0.07	40.95	0.00	0.00	0.00	16.74
Mexico	EWW	**(2.65)**	2.60	1.08	34.32	0.00	0.41	2.60	15.99
Chile	ECH	**(3.95)**	2.87	1.06	24.20	1.55	0.00	10.64	21.58
Turkey	TUR	**(6.35)**	5.50	1.31	25.96	0.00	0.66	4.80	**27.37**
Averages									
Top Four ETFs		11.21	3.33	0.89	37.17	5.84	17.57	6.25	9.74
Bottom Four ETFs		(3.82)	2.98	0.88	31.36	0.39	0.27	4.51	20.42