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Timely insights from portfolio managers and industry experts on key financial, economic and political issues.

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Equities

Market imbalances add to the case for international equities

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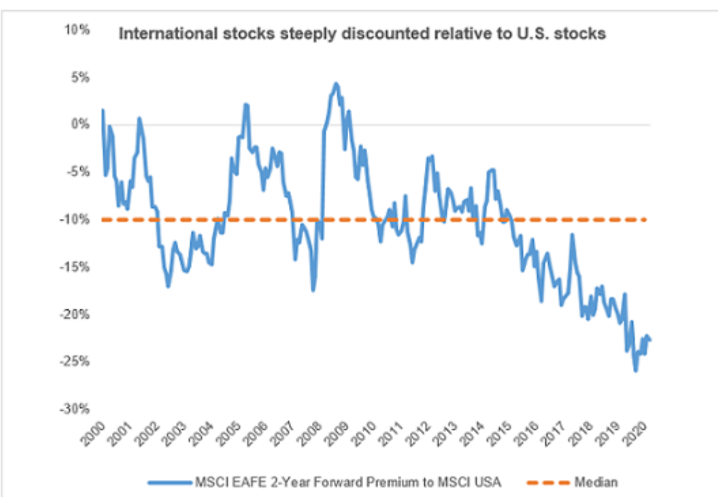
London - Many investors have watched the headlines around the WallStreetBets community on Reddit and the GameStop price swings with a combination of amusement and bemusement. Whether these dramatic share price moves are the ultimate expression of retail trading power or a sign that equity markets are flashing red, we believe one thing is clear: The U.S. equity market is displaying worrying signs of imbalance.

"In our view, recent price and trading patterns in U.S. stocks, along with worrisome economic imbalances, further strengthen the case for investing in international stocks."

For several months, Chris Dyer and I have been touting the case for international stocks versus their U.S. counterparts. In our view, recent price and trading patterns in U.S. stocks further strengthen this message. Along with the dominance of mega-cap tech stocks and full valuations we see at work in U.S. stock markets, international equities offer relative valuations that stand at multi-decade lows.



Source: FactSet, data as of March 8, 2021.

We believe successful portfolio management strives for two important goals: diversification and an attractive risk/reward profile. Our views stem, in part, from Nobel Prize-winning economist Harry Markowitz's simple but compelling findings in "Portfolio Selection," his seminal research paper of 1952.

Markowitz on diversification

One of Mr. Markowitz's powerful conclusions was that portfolio risk could be reduced through asset class diversification — now considered a fundamental tenet of investing. In looking at global markets today, our message is not to completely sell U.S. equity positions, but rather to consider portfolio rebalancing, including an allocation to international stocks.

We believe the U.S. equity market will remain attractive over the long term. The innovation and entrepreneurial dynamism that has characterized U.S. companies over past decades remains powerful. However, there are ever-more worrying signals for the U.S. stock market.

For some time, although the S&P 500 has delivered sizeable gains, the dominance of big technology companies in the index has reached alarming proportions. The emotional response to this, for many investors, is to resist selling for fear of missing out on ever-greater gains. Our message is: Take some of the impressive profits from U.S. equities and mega-cap tech names, and consider reallocating into other regions and markets. Think about your risk/reward tolerance and goals, and the realities of market rotation.

'Why now' for international equities

In recent months, economists worldwide have been upgrading their 2021 gross domestic product (GDP) forecasts. With heavy cost-cutting measures by companies and government support during the COVID-19 pandemic, corporate profit margins appear set to explode upwards. Last summer, we said that global economies were at the beginning of a multiyear cyclical recovery that favored large export manufacturing countries like Germany and Japan. These markets have delivered positive results in recent months and we believe will continue to do so.

In the U.S., ballooning debt, a weakening currency and the recent big move in the 10-year Treasury bond yield are creating consternation for investors. How will the mix of potential inflation, rising interest rates and alarming debt levels play out? The debate is not dissimilar in Europe and Japan, but the imbalances seem less alarming, less wide.

Lastly, we think valuation is a critical component in weighing portfolio risk/reward trade-offs. International stocks currently trade at a multi-decade low discount relative to the U.S. equity market. This clearly tilts one aspect of the risk-reward spectrum toward international equities.

Over recent years, we believe our portfolios have reflected our ability to find and invest in many interesting and attractive opportunities. Most of our portfolio holdings, however, do not attract the tidal wave of money from both retail and index funds that can, and one day are likely to, turn on a dime. Instead, we seek to build portfolios that try to deliver wealth creation over time, with an ability to weather storms such as the COVID crisis. Our strategy, as always, focuses on bottom-up stock picking and companies with sustainable business models.

Bottom line: We believe diversification and risk/reward measurements are key elements of successful portfolio management. Taking a regional perspective, we think international stocks now offer investors a compelling long-term opportunity.

Index definitions:

MSCI EAFE Index is an unmanaged index of equities in the developed markets, excluding the U.S. and Canada.

About risk: *The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. The value of equity securities is sensitive to stock market volatility. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. Investing primarily in responsible investments carries the risk that, under certain market conditions, a strategy may underperform those that do not utilize a responsible investment strategy.*