

International Equities — Are Investors Missing the Opportunity?

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The common belief that international equities can improve a U.S. portfolio's risk/return profile has lost support in recent years. Some market watchers point to greater correlations between non-U.S. and U.S. markets as evidence that the diversification benefits from investing abroad have eroded and do not warrant the additional risks associated with international investing.

Those investors who do take the international plunge often make two mistakes, in our view, that limit their ability to profit from non-U.S. investing, thus reinforcing the belief that investing outside the U.S. is no longer attractive. These mistakes include underweighting their allocation and failing to adequately define the asset class. This persistent home-country bias truncates the opportunity set for most investors and limits their ability to profit from structural changes in cross-border production and consumption patterns.

However, we believe there are compelling reasons to include or even increase international equity allocations today, and that the most effective method for obtaining non-U.S. exposure is through index-based strategies. It comes down to understanding the appropriate definition of beta for non-U.S. allocations and applying a similar risk-budgeting framework that supports U.S. core allocations.

International Equity Allocations Lag Behind Growth Opportunities

In assessing the benefits of investing outside the U.S., it's important to look carefully at the key trends emerging over the past four years. During the 1990s, investors worried that the diversification benefits of international investing were being eroded away and that volatility had become permanently higher than in the U.S. However,

current data shows that correlations have actually flattened and volatility increases have reversed — all positive trends for international investors.

Further good news for non-U.S. equities has been the improved terms of trade, transparency, and government deregulation that have fostered significant productivity gains and economic growth in a low-interest rate/low-inflation environment. This has led to a climate of strength in non-U.S. companies, markets, and currencies, and a shift in market dominance away from the U.S. in a number of industries.

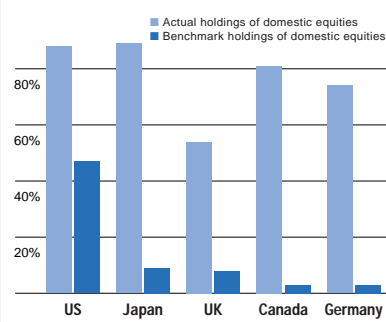
It's important to keep in mind that 95 percent of the world's population, 80 percent of world GDP, and over half of the world's listed equities are found outside the U.S. In fact, it is the rise of the middle class in many of the larger emerging markets, such as India, Brazil, China, and Russia, that is fueling a boom in domestic demand — and not simply export-led growth as has historically been the case.

While allocations to international equities have been rising, they are still not keeping pace with the global opportunity set. Perhaps not too surprisingly, this mismatch between actual holdings of equities and their benchmark representation is more pronounced in overseas markets than the U.S. market, as noted in Figure 1.

Adding Alpha by Redefining Beta

Beyond diversification and potential outperformance benefits, investors have the potential to gain alpha for their portfolios via a broader and

Figure 1: Actual & Benchmark Holdings Comparison

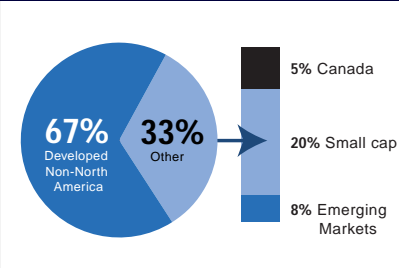


Source: Northern Trust Global Investments, International Monetary Fund

deeper definition of the beta associated with non-U.S. stocks. The standard non-U.S. market universe typically used by investors — the MSCI EAFE index — represents only two-thirds of the total international equity opportunity set. Because of this “benchmark gap,” institutional investors tend to systematically underweight or overlook Canada, as well as developed international small cap and emerging markets, which collectively account for \$4.1 trillion of non-U.S. equities’ \$12.6 trillion of investable capitalization. (Figure 2.)

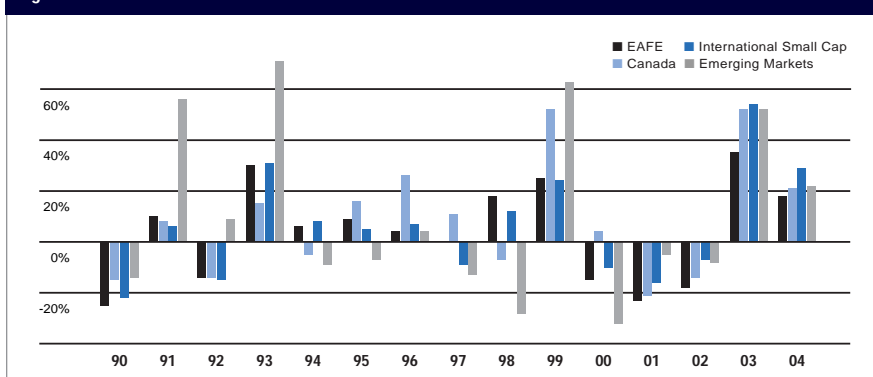
Yet all three of these market segments have had periods of dramatic

Figure 2: World Market Cap. by Region/Style



Source: Northern Trust Global Investments, Standard & Poor's, Morgan Stanley Capital International, Inc.

Figure 3: Differential Market Performance



Source: Northern Trust Global Investments, Standard & Poor's, Morgan Stanley Capital International, Inc.

outperformance relative to EAFE and its equivalents. (Figure 3.) Investors are leaving potential alpha on the table, and should consider shifting to more complete "total international equity" policy benchmarks concurrent with an increased overall allocation to international equities.

There are also correlation benefits to expanding the benchmark beyond EAFE. While correlations between the EAFE index and the S&P 500 have been rising, the other components of the international equity asset class demonstrate the value of maintaining broader exposure.

Table 1: Correlation with S&P 500 (1990-2004)

International Small Cap	0.53
Emerging Markets	0.63
EAFE	0.65
Canada	0.75

Source: Northern Trust Global Investments, Standard & Poor's, Morgan Stanley Capital International, Inc.

The "Arithmetic of Active Management" Also Prevails in International Equities

U.S. pension plan sponsors have become steadily more sophisticated in their choice of benchmarks and allocations for domestic equities during the past 10 years. The application of risk budgeting in this framework has resulted in extensive use of index-based strategies at the core of domestic allocations, and it is reasonably well-accepted that indexing has an important role for "efficient" markets

such as large-cap U.S. equities. In fact, most sophisticated investors now combine index, enhanced index, and traditional active management to build domestic portfolios to more efficiently achieve targeted levels of risk and return.

However, this logic is much less frequently applied to international equities. This is because the median active manager outperformed EAFE from the mid-1990s through 2001, according to InterSec universe data. But in 2000 and 2001, three important transformations in the framework for international equity investing were underway which diminished the opportunities for active managers to "outperform."

- Evolution of EAFE, FTSE, Dow Jones, and S&P equivalents to float adjustment, resulting in a deeper and more complete benchmark, better reflecting the true opportunity set available to active managers.
- More precise use of benchmarks — we call these "integrated international" strategies — by investors and their consultants. Active managers whose mandates allowed them to invest, or "dabble," in emerging markets were increasingly measured against benchmarks that included these developing countries.
- Costs and research intensity was converging to U.S. levels, especially in Europe, with increasing integration and adoption of the Euro.

The relative performance of active international managers since the early

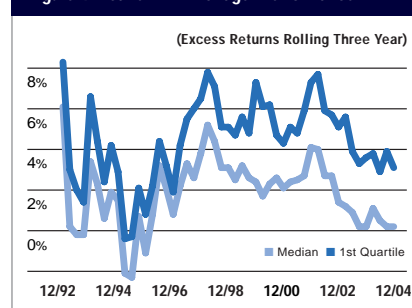


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2000s has begun to look more like that of domestic active managers (Figure 4). And, like their U.S. counterparts, the median manager in most non-U.S. universes is increasingly struggling to outperform³.

While this is not an indictment of active management, it should serve to remind investors that they must have deep confidence in their chosen manager's ability to deliver outperformance in the future.

Figure 4: Active EAFE Manager Performance



Source: Northern Trust Global Investments, InterSec

Thus, the logic and arithmetic of using index-based strategies at the core of one's international equity commitment is growing more compelling as non-U.S. markets mature. We believe that investors who adopt this approach will benefit in the same ways, with more efficient and consistent exposure to the dynamic companies and economies beyond American shores. ■

1. International Monetary Fund, World Economic Outlook, April 2005.

2. William F. Sharpe, "The Arithmetic of Active Management," Financial Analysts' Journal (January/February 1991).

3. Steven A. Schoenfeld, "Watch out, active managers, for the new EAFE." Pensions & Investments (November 12, 2001).

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