Buying International

In investing, the most normal inclination in the world is to question why an underperforming investment was included in the portfolio. Recently, those questions have surrounded international stocks. Since January 2008, international stocks have consistently underperformed the U.S. S&P 500 index to the tune of 6.5 percentage points a year. Why not go ahead and ditch those foreign stocks and buy American?

A recent report in the *Journal of Portfolio Management* acknowledges that, in fact, international equities have actually underperformed U.S. large cap stocks for the past 30 years. But looking back over longer time periods, it found some interesting insights which might be relevant today. Reviewing the past three decades, the researchers noticed that U.S. companies were not actually performing better, or growing faster, or becoming more profitable. Instead, investors were increasingly willing to pay more for U.S. stocks during that time period. Another way of saying that is that the valuations tripled, as measured by one common measure of price/earnings ratios.

Looking further back in history, the researchers noted that U.S. equities underperformed the EAFE (international stock) index in three of the past five decades: the 1970s, 1980s and 2000s.

What does this mean for investors who are impatient with their international stock performance? It means that returns move in hard-to-predict cycles. International will sometimes outperform U.S. for long periods of time, and then (as has happened recently) the reverse happens—all of this unpredictably. It also means that U.S. stocks are pretty expensive right now; the Cyclically Adjusted PE Ratio is currently up around 30.1, well above the historical mean of 17. If investors decide that the earnings U.S. stocks are worth something closer to what they have paid historically, we could see a pullback in valuations—and those international allocations will become the future hero of investment portfolios.

But aren't U.S. companies inherently superior to companies located in other countries? A whitepaper published by the U.S. Federal Reserve notes that the U.S. has experienced some unique tailwinds to its stock prices over the last 30 years. Both interest rates (meaning the cost of borrowing) and tax rates declined steadily over that period. As a result, profit growth exceeded the overall growth of the economy. But today, both interest rates and tax rates are likely to rebound, turning the tail winds into headwinds.

None of this suggests that we can actually know anything about what will happen tomorrow, or next year, or even the next several years. All we know is that buying or selling based on yesterday's information seldom leads to great outcomes. Just ask investors who decided to go all-in on Japanese stocks in 1990, after Japanese stocks had experienced several decades of radical outperformance. The subsequent returns have been dismal, and with the benefit of hindsight we can see that those investments were significantly overvalued.

Sources:

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