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May 2016

International Asset Allocation

A. Craig MacKinlay, Ph.D.

acmackinlay@prudentmanagement.com

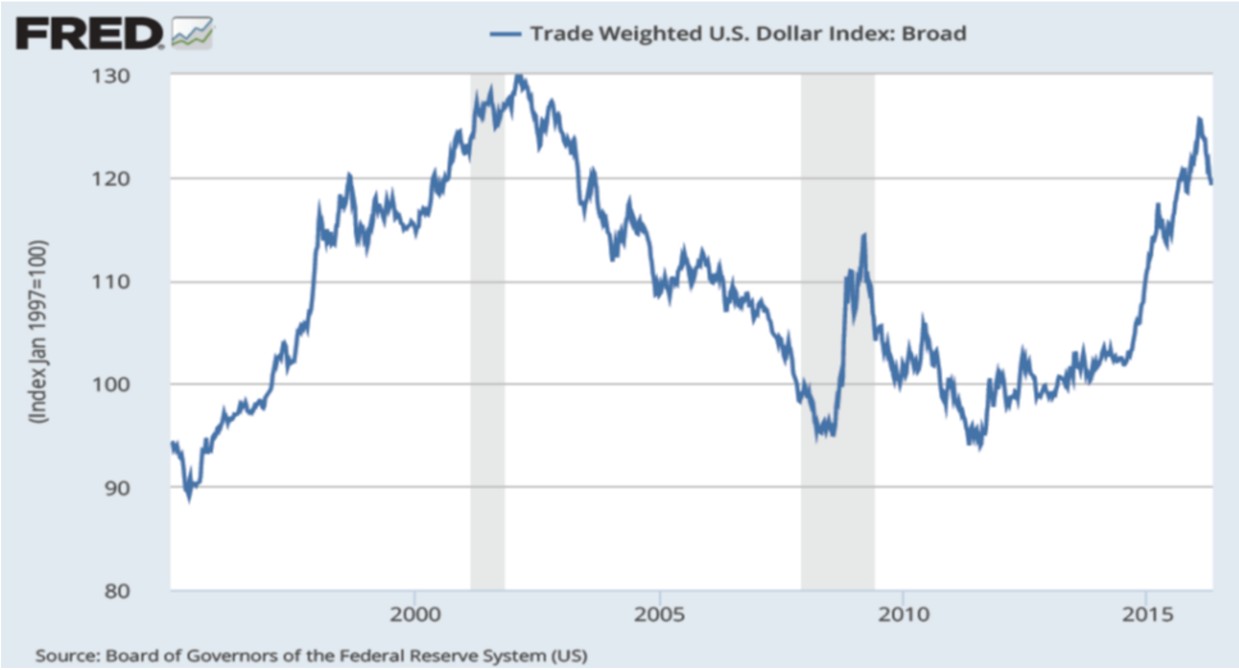
Over the past several years, investments in the U.S. stock market have had a higher annualized return than investments in non-U.S. markets when viewed from the perspective of an U.S. investor. For the five-year time period ending on April 29, 2016, the S&P500 index provided on average an annual return of 11.02%. In contrast, the MSCI ACWI ex USA[1] was basically flat with an average annual return of -.13% in U.S. dollars. As discussed in last May's edition of Partner Talk, this large performance difference naturally leads to questions of the benefits of an international allocation in investment portfolios, a topic that is considered in this edition of Partner Talk.

One can ask the question – "What drives return differences across markets?" It is the case that, in a macroeconomic sense, the relative performance of markets does depend on economic activity and fiscal imbalances around the world as well as the actions of central banks. However, building a macroeconomic model to explicitly capture such effects is complicated and soon becomes intractable. A simpler way to think about the return differences is to recognize that because international returns are ultimately translated into U.S. dollars, the strength of the dollar plays a key role. Indeed, this has been the case in recent periods.

One measure of the strength of the U.S. dollar is the Trade Weighted U.S. Dollar Index (broad version) published by the Federal Reserve Bank. The index is a measure of the value of the United States dollar relative to other world currencies.

[1] The MSCI ACWI ex USA Index captures large- and mid- cap representation across 22 of 23 Developed Markets countries (excluding the US) and 23 Emerging Markets countries. The index covers approximately 85% of the global equity opportunity set outside the US.

The chart below shows the value of this index from January 1997 through April 2016.



From this plot of the dollar index it is evident that the dollar has had episodes of strength and weakness. For example, for the five years ending in April 2016, the dollar appreciated on average 4.73% annually, contributing significantly to the recent relative weakness of international markets previously cited.

On the other hand, if the earlier five-year period ending with April 2011 is considered, the U.S. dollar actually depreciated by on average 2.82% annually. And over this period, the U.S. market as measured by the S&P 500 index on average returned 2.95% annually, whereas on average the MSCI ACWI ex US index on average had an annual return of 3.56%. This period of underperformance of the U.S. market can be related to the weak dollar.

We have again had a weaker U.S. dollar over the first four months of this year with the dollar index declining by 3.68%. In this environment, the return of the international index has been 2.25% and the return of the S&P500 index has been 1.74%, a result once again consistent with the expected role of the exchange rate. The bottom line is that in a strong dollar environment, international stocks will generally underperform. And in an economic environment where the U.S. dollar weakens, strong international performance is likely.

It is worth noting that the observed return difference across markets does not necessarily fully reflect the strength or weakness of the dollar since exchange rate movements also impact U.S. based global companies through the impact on earnings. For example, Coca-Cola in its recent quarterly earnings release noted that first quarter cash flow from operations was negatively impacted by fluctuations in foreign currency exchange rates. However, while exchange rate movements can impact the value of U.S. based corporations, as an empirical matter, the currency fluctuations do have a more direct effect on the value of corporations domiciled abroad.

The importance of exchange rate movements suggests that an accurate forecast of the path of the dollar would be very useful for international asset allocation decisions. However, evidence supporting the predictability of the future value of the U.S. dollar does not exist. The model with the most empirical support for the behavior of the U.S. dollar is the “random walk” hypothesis. If exchange rates follow a random walk, future changes in the value of a currency are not forecastable and periods of strong or weak dollar performance cannot be predicted.

So, why maintain international exposure? The lack of predictability of future exchange rate movements argues against using international funds as a means to generating higher returns. However, this lack of predictability doesn’t mean that there are not diversification benefits from international exposure. International exposure can play a useful role from a risk control perspective. In fact, over most historical periods, a carefully constructed portfolio including both international funds and U.S. funds will have lower risk than the U.S. portfolio itself. Importantly, this lower risk can be achieved without a significant sacrifice on the return dimension.

At PMA, risk control is a key part of the investment process. Prudent Management Associates carefully analyzes the risk of international markets jointly with the U.S. market to determine an optimal allocation to international that will create a portfolio with the highest risk-adjusted return. At present, PMA targets an allocation of only 20% of our equity investment to international equity notwithstanding that international equity constitutes more than 50% of global market capitalization. If justified, this target allocation will be changed as risk measures are updated with the evolving economic environment. This is an important part of the risk control process. Because holding international stocks can reduce portfolio risk by increasing equity diversification and can contribute to stronger risk-adjusted returns, Prudent Management Associates believes that our portfolios continue to benefit from a conservative allocation to carefully selected international equity funds.