First Ascent Asset Management

WHY INVESTING IN US & INTERNATIONAL STOCKS STILL MAKES SENSE

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US & INTERNATIONAL STOCKS

US stocks have outperformed international stocks for the better part of the last 10 years. US firms, generally, have grown faster and been more profitable than international firms. The US has less regulation and a better business environment than most international markets. Many US firms are global market leaders and just seem more innovative than international firms.

All the above statements are true. Yet it still makes great sense to have a significant allocation to international stocks. Here's why:

The differences between US and international markets are already priced into those markets.

In an efficient market, stock prices are driven by future expected earnings. There is no reason (all other things being equal) that an investor would pay more for a dollar of future earnings from a US firm than for a dollar of future earnings from an international firm. Money is money.

For example, let's say I believe the US market will generate $10 of future earnings and international markets will generate only $5 of future earnings. Then it shouldn't matter to me if I pay $100 for a share of the US market or $50 for a share of the international markets. Either way I am paying exactly the same thing for a dollar of future earnings.

So, even if US firms operate in a more favorable business environment, grow faster, generate more earnings, and are generally more innovative than international firms you shouldn't dump your international stocks. You should just pay less for them.

This is true, all other things being equal. But all other things are never equal. There are differences between US and international markets relating to taxes, currencies, regulations, political stability, and a host of other risks and issues.

These differences are also priced into the markets.

If "Mr. Market" has considered all the relevant factors, weighed them correctly, and there are no changes or surprises, then it should not matter if you own US or international stocks. All the differences between US and international markets should be reflected in their relative prices.

And that is exactly what happens. As of June 30, 2020, the average price/earnings ratio (P/E) of the stocks held by the Vanguard Total Stock Market ETF (VTI) was 23.2. VTI broadly tracks the US stock market. The average P/E of the stocks held by the Vanguard Total International Stock ETF (VXUS) was 17.1. VXUS broadly tracks the international stock markets.

That means, in effect, that investors were willing to pay over 35% more to own a share of the US market than to own a share of the international markets. Mr. Market is performing as you would expect in a world where US markets are viewed more favorably, for the reasons enumerated above, than international markets.

So, even in a world where nothing changes it makes sense to allocate a portion of your portfolio to both US and international markets. US and international markets do not rise and fall in perfect sync, so there is still a diversification benefit that comes with owning both. And owning international stocks expands the universe of market-leading brands available, which can decrease portfolio risk.

But the factors that go into Mr. Market's calculations are highly dynamic. They can change rapidly and dramatically. Global economies compete for advantage. World events alter the fortunes of nations. There are winners and losers. The world is in a constant state of flux.

The way Mr. Market values assets changes too. Sometimes stock markets are "cheap," and it costs less to buy a dollar of earnings. Sometimes markets are "expensive," and it costs more. The relative valuation of US and international markets also changes over time, so the size of the gap between what investors will pay for US and international stocks varies.

We see the impact of all these changes reflected in the relative returns of US and international markets over time. US and international markets regularly exchange performance leadership. Since 1975, the leadership cycle has lasted an average of 7.6 years. As of June 30, 2020, we are 9.3 years into the current cycle of US outperformance. Are we due for a change?

The simple passage of time will not cause the cycle to flip. But changes in the factors considered by Mr. Market and changes in the way those factors are weighed and valued will.

For example, assume that both US and international economies are successful in improving their respective earnings environments. But assume that international firms improve their earnings growth rates more than US firms. If that happens, international firm share prices will be adjusted upwards at a higher rate resulting in higher performance relative to US firms.

In this scenario, international firms do not need to earn more than US firms on an absolute basis to outperform them. They simply need to exceed Mr. Market's expectations for them by more than the US market does.

Currently, there are a number of very well-respected firms that expect a change in the cycle of outperformance. One is Schwab, which in June 2020 predicted a 7.1% return for large cap US stocks vs. a 7.7% return for international stocks over the next 10 years.

Schwab believes the outperformance of international markets will be driven by a narrowing of the valuation spread between US and international markets (the difference in their P/E ratios). In other words, they are expecting the 35% premium mentioned above to narrow.

Vanguard's July 2020 prediction was even bolder: 4%-6% for US stocks and 7%-9% for international stocks in the coming decade. Like Schwab, they believe international outperformance will be driven primarily by a narrowing of valuation spreads.

Research Affiliates predicts a more dramatic change in performance leadership over the coming decade. It expects large cap US stocks to return 2.4% and small cap US stocks to return 4.4%, while developed international stocks return 7.2% and emerging markets stocks return 9.3%. Its August 2020 prediction is based on an analysis of future cash flows and changes in valuations.

Will these predictions be correct? No one knows. That's why it is advisable to hold significant investments in both US and international stocks. The markets do their best to price in all the differences between US and international markets, but the future is impossible to predict.