RE-DEFINING RISK FOR INTERNATIONAL EQUITY INVESTING

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For investors seeking to diversify their portfolios and access the growth opportunities in equity markets outside of the United States, the issue often receiving the greatest attention is whether an “active” or “passive” investment approach presents the best route to success.

Advocates of the discretionary active approach – where an investment manager attempts to add value principally through stock selection – place confidence in the skill and proprietary insight of the manager to own a subset of companies contained in an index, and, simply stated, pick the winners and avoid the losers.

The long-term evidence highlights the difficulty of this task. The fact is that the majority of actively managed international equity funds fail to beat their reference index benchmarks on a pre-tax basis, once the explicit cost of such strategies (management fees1) and implicit costs (return dilution due to trading and turnover frictions) are taken into account.1 For taxable investors the hurdle is even higher, since the generally lower post-tax versus pre-tax returns of such strategies further handicaps the likelihood of success versus a simple indexed approach.

Promoters of the passive indexed approach to international equity investing – whereby the investor simply owns more or less the entire opportunity set of companies and countries in a cost- and tax-efficient manner – use the logic above to support their case. And, unless an investor believes that they have the ability to pre-identify the minority of active managers that might beat the index looking ahead, such logic is hard to refute.2

Missing the Forest for the Trees?

Yet there is a far more fundamental question that often goes unaddressed in the active versus passive debate, and that centers on the issue of country risk and its implications for investment allocations across countries.

Most indexed international equity strategies rely on capitalization weighting to allocate across countries and their underlying companies. And most actively-managed international equity strategies – which are benchmarked to such cap-weighted indices – slice closely to index country weights, seeking to add value through individual company selection.

A deeper look at leading capitalization-weighted international equity indices that guide both passive and active strategies raises two important considerations.

First, they are highly concentrated in countries representing the minority of index constituents. For example, the MSCI All Country World Index ex-US (ACWI ex-US)3, containing exposure to 44 countries, allocates approximately one-third of the index weight to the top three countries; by the time you get to the tenth largest country, close to three-quarters of the index’s allocation is accounted for. From a risk management perspective, that would suggest significant concentration in both single country risk, as well as a high degree of currency exposure concentration.

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1 The current median expense ratio for active international equity funds tracked by Morningstar is 1.28%.
Second, delving into the concentrated group of countries that dominate exposure in cap-weighted international equity indices reveals that they are principally represented by developed nations in Western Europe, and Japan. In the ACWI ex-US Index, for example, such developed nation exposures are close to 80 percent of the overall index, with emerging countries representing the balance.

This should not be surprising, as the size of each country’s equity market is heavily influenced by the maturity of both its economy and history of capital markets development. However, such concentration results in heavy exposure to countries that, in general, are experiencing low levels of economic growth, significant debt and deficit encumbrances and are facing significant demographic and entitlement challenges ahead.

This is starkly evidenced in considering the International Monetary Fund’s (IMF) most recent World Economic Outlook2 and its projections for Gross Domestic Product (GDP) growth across countries over the next five years. Mapping these GDP growth forecasts to current country weights in capitalization-weighted international equity indices indicates that approximately 80% of such indices are allocated to the countries that are projected to generate 20% of the world’s (excluding the United States) economic growth over the next five years, while the remaining countries representing 20% of such indices are projected to generate 80% of the growth.

And countries in the latter contingent generally represent the mirror image of those in the former across a number of key risk dimensions that can influence future rates of growth and the productivity of the private sector: lower levels of government debt, lower levels of deficits, lower government spending as a percentage of economic output, lower tax rates, higher rates of population growth, lower dependency ratios (population above the age of 65) and a lower median population age.

While starting from a lower base, such countries are also making positive progress across economic freedom factors (such as those detailed in studies like the Heritage Foundation’s Index of Economic Freedom3, e.g., property rights, openness to trade, ease of starting businesses, pro-growth tax policy, etc.), while many developed countries that account for index concentration have regressed along these dimensions in recent years.

A large number of developed countries facing slow economic growth and high unemployment are also undertaking extraordinary monetary policy measures, which may have negative future implications for inflation and currency values, while emerging economies, in general, are applying more discipline in monetary policy than their developed market counterparts.

And emerging countries – earlier in their development cycle and now playing catch-up in technology adoption and infrastructure buildout – present the likelihood of sustained higher economic growth and the expansion of a private sector and capital markets, starting from their low bases relative to developed economies.

Based on estimated differentials between developed and developing countries in their projected real earnings and dividend growth rates, equity market valuations and currency exchange rates, a recent analysis by Goldman Sachs3 estimated that the equity market capitalization of emerging countries will

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2 IMF World Economic Outlook, April 2013
3 “EM Equity in Two Decades,” Goldman Sachs, March 15, 2013
grow at a compound rate of almost three times that of developed countries looking forward over the next two decades to 2030.

Towards a More Balanced International Equity Portfolio

In thinking through how to design a more balanced set of exposures to the international equity opportunity set, a variety of approaches can be considered. A starting point might be to conclude that emerging market exposure is too low and developed market exposure too high (and concentrated) in international equity indices.

This might suggest applying some ad-hoc decision to re-weighting countries in an international equity portfolio – say, putting half in emerging markets and half in developed markets. Or, perhaps, just giving each country included in such a portfolio equal weights.

Yet, these approaches are problematic in that they don’t consider the differences in risk characteristics across countries and would likely result in a portfolio that has a very uneven allocation of risk across its constituents, hence suffering from some of the concentration criticisms of a cap-weighting approach.

An investment approach that has recently been gaining significant adoption by sophisticated institutional investors is known as “risk parity.” The conceptual framework here is that having a similar dollar amount invested across a series of assets can cause an unintentionally high concentration of risk. The example most often cited to explain the risk parity concept is that of the 60/40 stock/bond portfolio, where the 60% equity allocation actually constitutes more than 90% of the portfolio’s risk, given the higher volatility of equities relative to bonds. A risk parity strategy would see to correct this imbalance by assigning new weights to the stock and bond components, so that each allocation is contributing equal risk to the overall portfolio.

Similar intuition might be applied to thinking about investing across equity markets. Certain countries, for instance, may have highly liquid markets, diversification across industry sectors and less sensitivity to a single risk factor like changes in oil prices. Other countries may have less liquid markets, with higher sector and stock concentration.

Investing an equal dollar amount in each country described in this contrast would result in a portfolio that had disproportionate risk allocated to the first country.

Taking the risk parity concept a step further in thinking about its application to international equity investing suggests that the use of simple volatility to define a country’s risk may be misleading. For example, two countries with very different risk characteristics (as hypothetically contrasted above) may have very similar volatilities during “normal” market windows, yet during periods of market turbulence exhibit material differences in their downside vulnerability.

In the design of the Vident International Equity Strategy Index, a first process layer seeks to allocate a similar level of downside (or “left tail”) risk contribution to each country in the index. The intended result is a more balanced and diversified allocation of risk across the countries comprising the index than

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4 As is typically the risk measure used to construct multi-asset class risk parity portfolios
5 Subject to liquidity tiers to ensure investability
would be experienced in using a cap-weighted international equity index, or active international equity strategy conforming closely to country weights in its benchmark index.

The result of this approach is also to bring the allocation across developed and emerging countries into a more balanced state, improving the composite characteristics of the Vident International Equity Strategy Index versus a cap-weighted approach, with:

- Higher composite economic growth
- Lower composite government debt-to-GDP and composite deficit-to-GDP
- Lower composite government spending-to-GDP, lower composite tax burden-to-GDP and lower composite marginal tax rates
- Improved composite demographics with respect to median age, population growth and dependency ratios (population over the age of 65)
- Improving, versus regressing, composite measures of economic freedom (as measured by the Heritage Foundation’s Index of Economic Freedom)
- Higher composite corporate earnings growth

And from a risk diversification perspective, the Vident International Equity Strategy Index is far less concentrated in individual countries and currencies than the cap-weighted approach.
Enhancing the Baseline Risk-Weighted Country Allocation

Starting with the baseline risk-weighted country allocation approach described above, the Vident International Equity Strategy Index also considers explicit country fundamental risk factors, valuation, corporate fundamentals and investor sentiment to systematically “tilt” country allocations from their baseline risk weight, seeking to further improve the index’s responsiveness to these evolving dynamics.

These factors are combined with the risk-weighted baseline approach to result in a rules-based and systematic investment process, codified in the Vident International Equity Strategy Index.

While the term “index” is often considered synonymous with investing “passively,” the Vident International Equity Strategy Index intentionally diverges quite significantly from traditional cap-weighted international indices with respect to its allocation across countries and its composite risk characteristics, with the goal of improved success in capturing returns available across international equity markets.

In these respects, we believe it is likely more “active” than many traditional actively-managed international equity strategies, in terms of systematically arranging asset exposures in a manner that will exert significant influence on overall risk/return characteristics. However, it is consistent in its application of decision processes – as codified in the strategy index – and seeks to eliminate the potential behavioral shortcomings of strategies that rely on ongoing discretionary decisions of a single portfolio manager or team.
In seeking to materially improve composite portfolio characteristics across multiple dimensions of risk as discussed throughout this piece, the Vident International Equity Strategy Index seeks to provide an innovative approach, rooted in economic logic and intuition, to participating in the equity opportunity set outside of the United States.

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i S&P Indices Versus Active Funds (SPIVA) Scorecard, Mid-Year 2013, Aye M. Soe

ii Advantages of “passive” investment strategies include more comprehensive market capturing, broad diversification, less trading (lower fees, less capital gains tax distributions) and typically less risk and volatility. While advantages of “active” strategies include more precise selection for buying particular investments (stocks, bonds, etc.) and trying to avoid the wrong ones, flexibility for attempting to time the market and potential for higher returns, yet also with higher costs, risks and volatility typically.

iii MSCI ACWI ex US Investable Market Index (IMI) captures large, mid and small cap representation across 23 of 24 Developed Markets (DM) countries (excluding the United States) and 21 Emerging Markets (EM) countries.

iv Heritage Index of Economic Freedom - an annual index created by The Heritage Foundation and The Wall Street Journal in 1995 to measure the degree of economic freedom in the world’s nations.

v Volatility is the amount of uncertainty or risk about the size of changes in a security’s value.

vi Vident International Equity Index™ (VIE) is a strategy seeking to balance risk across developed and emerging countries and emphasize those with favorable conditions for growth.