ABR Dynamic Funds' Series on Stagnation Solutions: Part 4
International Equities

Preface

In the first installment, we noted that, at the time this series was written, the S&P 500 Shiller cyclically-adjusted price to earnings ratio (CAPE) was approximately 30 (of course, that can change quickly), and that value has historically indicated a next 10-year annualized return for the S&P 500 of about 3%. The last time the S&P 500 Shiller CAPE was about 30 was near the beginning of 2002. Over the next decade (2002-2011), the S&P 500 annualized return was 2.9%. Therefore, we have chosen that 10-year period to illustrate the equity replacement possibilities throughout this series. That choice reflects neither (1) a prediction that the next 10 years will play out just like the decade from 2002-2011, nor (2) a belief that the Shiller CAPE's forecasts are quite that accurate over time.

International Equities

The Shiller CAPE ratio in the U.S. (specifically on the S&P 500) is historically high, but that doesn't mean it is high around the world. International equities have generally performed worse than U.S. equities over the past few years, and that is partially due to the fact that international equities have generally not grown as expensive as U.S. equities over that same time frame. A glance at CAPE ratios around the world shows figures of 8 and up, and indicates the possibility (although CAPE ratios bring no certainty, of course) of better results over the next decade from some international equity markets.

The MSCI EAFE USD Index (NDDUEAFE Index) represents exposure to large and mid-cap stocks, focusing on developed economies around the world, excluding the U.S. and Canada. It has significantly underperformed the S&P 500 Index for the last 8 years. That may sound bad, but, from the perspective of CAPE ratios, it isn't bad. From that perspective, it may mean these stocks aren't as expensive their U.S. counterparts.

The following graph shows the NDDUEAFE Index and the S&P 500 Index over the decade from 2002-2011, for reasons covered in the preface. **As the graph shows, NDDUEAFE Index outperformed the S&P 500, producing a 4.70% annualized return over this decade (vs. the now familiar 2.92% for the S&P 500 Index).** As with all of the choices in this series, NDDUEAFE Index was chosen for illustration purposes and not as an endorsement.
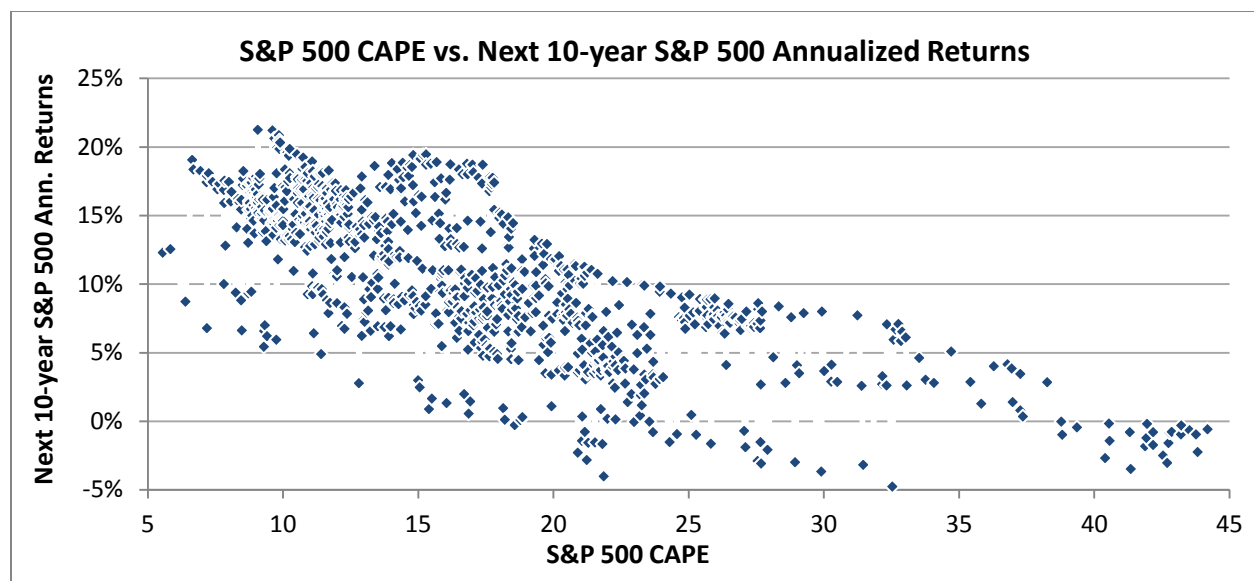
NDDUEAFE Index (red) and S&P 500 Index (white), 2002-2011

+58.25% (+4.70%ann.)

+33.35% (+2.92%ann.)

157.7847

133.3519

2002 2003 2004 2005 2006 2007 2008 2009 2010 2011

Source: Bloomberg

Additional Observations

- The same CAPE ratios from different markets have not implied the same upcoming returns, and thus should not be directly compared to each other. Each market's CAPE ratio needs to be compared to its historical values and the upcoming returns those values have implied.

- CAPE ratios have, of course, not been perfect tools for predicting returns. In the U.S. for example, a particular CAPE ratio has historically implied a range of upcoming 10-year returns, shown in the following graph.

S&P 500 CAPE vs. Next 10-year S&P 500 Annualized Returns

(chart: x-axis "S&P 500 CAPE" from 5 to 45; y-axis "Next 10-year S&P 500 Ann. Returns" from -5% to 25%)

Data source: Bloomberg and multpl.com

- U.S. equity replacements (such as many international equity strategies) that are selected in part for risk/return profiles that have been similar to the S&P 500 should not be mistaken for significantly diversifying allocations. We've called them replacements, after all.

Next Week's Preview: Some long-only (or net long) equity factor strategies have outperformed the S&P 500 during decades of lower S&P 500 returns.

Notes/Disclosures