International Investing

This chapter was contributed by The Brandes Center. The Brandes Center, formally opened in 2022 thanks to the philanthropic vision of Charles Brandes, examines potential investment approaches that arise from structural and behavioral factors in global markets. Our research seeks to uncover investment strategies that may address long-term needs for institutional and individual investors.

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"From the start, global investing just seemed like a natural extension of a purpose-built value discipline. In fact, I didn't even consider it global investing—it was value investing. After all, when you're looking at a business from the ground up, the soil it sits on really doesn't matter most of the time."

--Charles Brandes, CFA

Section 1 What is International Investing?

International investing allows an investor to explore the range of opportunities outside the borders of the investor's home country. These opportunities enable potentially rewarding investment strategies that may justify the increased complexity of investing outside a familiar home market.

In this Chapter, we cover equities, bonds and currencies in developed and emerging markets. We provide historical and global context, as well as outline the main practical issues faced by international investors.

The objective of the Chapter is to help SMIF investors evaluate the rewards against the costs and risks, so that they can make an informed decision on whether and how to incorporate a broader, global perspective into their investment strategy.

A note on terminology: "international investing" is generally used to describe investing outside one's home country. As a result, the international investing universe varies, depending on the home country of the investor. "Global investing" is typically used when referring to the investment universe worldwide, *including* the investor's home country, and thus the global investment universe is the same for all investors, regardless of location.

International Equity Indices

There are a number of index providers covering the world's equity markets. The MSCI All-Country World Index (known as "ACWI") provides a good illustration of the broad geographic scope available globally. It includes 23 developed and 24 emerging markets (DM and EM, respectively) as of March 31, 2022[1]. Developed markets are generally larger and more established, so they represent the bulk of ACWI by capitalization, at approximately 89%, with the other 11% representing emerging markets.

For US-based international investors looking only at developed markets abroad, the appropriate MSCI index is "EAFE". The initials stand for **E**urope, **A**ustralasia (encompassing Australia and New Zealand) and **F**ar **E**ast. EAFE is commonly mentioned in the media when discussing international investing, and it's important to remember that EAFE is a subset of ACWI. Not only does it exclude the US, but also Canada and EM countries. For international investors looking to broaden their coverage, the MSCI ACWI ex-US

[1] Any reference to current statistics in this Chapter refers to 3/31/2022 unless otherwise stated

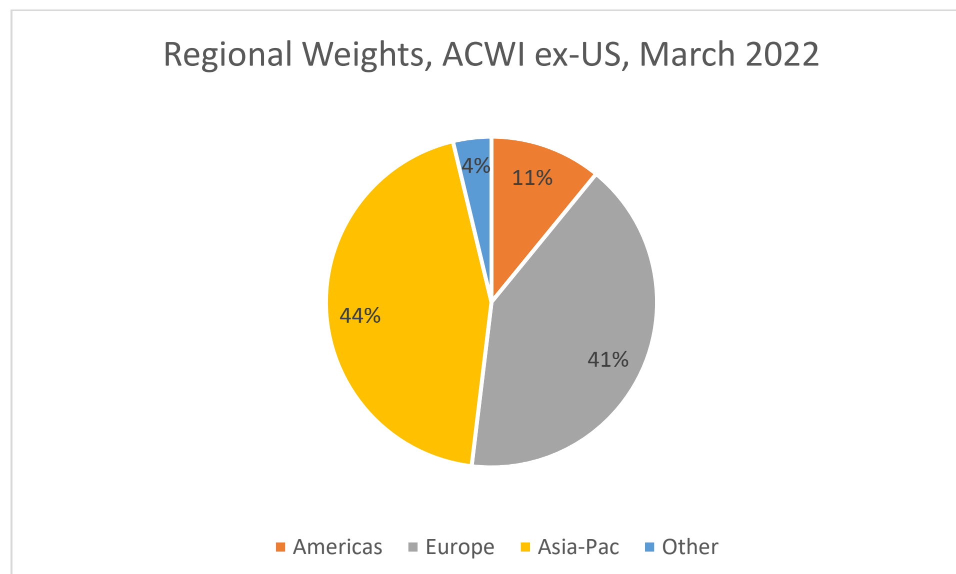
index is suitable, including EM and Canada. As its name suggests, ACWI ex-US includes all developed and emerging markets except the US.[2]

If investors were seeking to invest *only* in emerging markets, they could use the MSCI EM Index as a benchmark. (For more about emerging markets investing, see Section 5 of this chapter.) The MSCI EM Index includes 24 countries from three regions—the Americas; the EMEA region (Europe, the Middle East and Africa); and Asia.

The US is significantly the largest of the world's stock markets, representing 61% of ACWI by market capitalization. The largest stock markets outside the US are (in size order within ACWI) Japan, UK, China, Canada and France. China is classified as an emerging market; the other four are developed markets.

Focusing specifically on the non-US markets, Fig 1-1 shows the regional breakdown of ACWI ex-US. Europe and Asia-Pacific are the two largest regions by market cap, followed by the Americas (Canada and Latin America), and a small weight in other markets including the Middle East and Africa.

Fig 1-1: ACWI ex-US market cap weight by region



Source: MSCI March 31, 2022

Over time, the percentage split of world equity markets has shifted due to relative price movements and changes in the number of companies listed. In recent years, the most notable change in the ACWI weights among developed markets has been the rise of the US percentage. A decade ago, this was under 50%. The flipside of this is the decline in the weights of other markets in the last ten years, notably Japan (down 2% to 6%) and the UK (down 4% to 4%). Historically, some of these shifts in weighting have been significant, particularly when price trends in the largest markets are out-of-sync over extended periods. For example, after Japanese stocks rose dramatically in the late 1980s, Japan's weight in ACWI briefly exceeded 40% and the US weight dipped below 30%.

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[2] For more information on how developed and emerging market countries are classified, search online for MSCI's "Annual Market Classification Review." The most current edition (at the time this chapter was written) could be found here.

Exercise 1-A

At its peak valuation in 1989, Japan's market weighting in ACWI was more than double its GDP weight as a percentage of the world economy. Research the current weight of the US GDP as a percentage of world GDP and compare it to the US market weighting in ACWI. Discuss: Is this situation different from Japan's situation in 1989? Why or why not?

A notable change also has occurred in emerging markets. In recent years, China's equity markets have grown and become more accessible to global investors. China's weight in the EM index was under 1% on entry in 1997, reflecting the very limited availability of Chinese stocks. It is now the largest component of the index at over 30%. This already is a big change, but it should be noted that these index percentages reflect only a proportion of the market cap of Chinese stocks, as that country's markets are still only partially open to non-Chinese investors.[3]

International equity investors also need to be aware that they are investing in companies, not countries. Just because it seems convenient to start at a country or regional level, an investor is not buying "Japan" or "Germany," even in a passive strategy. The investment is in a portfolio of company-specific securities and may not necessarily reflect the local economy, especially if the local stock market has a predominance of global firms (e.g., Switzerland and the Netherlands), or a significant number of exporters (e.g., Japan). It's important to examine the sector composition by region and country in order to understand better the available opportunities. Even a high-level comparison of the US, EAFE and EM indices shows significant differences in sector weights. See Fig 1-2.

Fig 1-2 Differences in sector weights between US and international indices

SECTOR WEIGHT MAJOR DIFFERENCES	**US wt minus ACWI ex US wt**
Financials	-9.7%
Materials	-6.3%
Industrials	-4.4%
Health Care	4.1%
Infotech	16.6%

Source: MSCI, March 31, 2022

The US has an aggregate 20% overweight in two sectors, Information Technology and Health Care. In contrast, the international markets have an aggregate 20% overweight in Financials, Materials and Industrials.

The EM sector profile is more similar to EAFE than it is to the US. Compared to EM, the US has a 17% overweight in the same two sectors (Infotech and Health Care), and an 18% underweight in Financials and Materials.

[3] Sources for data in this section from: https://en.guidingdata.com/msci-acwi-country-weighting-last-10-years/ and MSCI 3/31/22, https://www.msci.com/our-solutions/indexes/emerging-markets.

Exercise 1-B

Split your SMIF team into two groups. One group should construct an international country/sector allocation by first choosing country weights relative to the EAFE Index for the ten largest countries (group the other countries together into “Other”) and then deciding sector weights in each country. The second group should first choose sector weights (regardless of country) and then for each sector, decide country weights (for up to ten countries at most) within that sector. The two groups then should compare the two allocations, and discuss to what extent (and why) the order of country/sector decisions influenced their ultimate allocation.

Currencies

Any investor going outside domestic markets must cope with currency issues and decisions. These can be broken down into four broad topics:

- Exposure: An investor in non-domestic securities is exposed to currency fluctuations.
- Trading/settlement: To trade non-domestic securities in local markets, the investor generally needs to settle in local currency and maintain local currency accounts.
- Hedging: It is possible to remove the local currency exposure by hedging back into US dollars. Investors can do this most simply in currency markets by selling forward the required amount of local currency.
- Currency investment: Separately from any exposure to currencies from owning or settling underlying securities, investors can also take positions in currency with a view to making speculative gains.

For US-based investors aiming to handle currencies in the simplest way, many non-US equity securities (or collective vehicles) can be accessed in US markets in US dollars (for example see ETFs, mutual funds, or ADRs in Sections 8 and 9 of this Chapter). Note that while this removes the need for trading and settling via local currency, investors are still exposed to the underlying currency; this is implicit in the price of these instruments. In some cases, it is possible to remove that currency exposure if the ETF or mutual fund is—or offers—a “currency-hedged” vehicle.

The size and trading volume in world currency markets is much larger than that of the securities markets. As well as investors, participants in currency markets include businesses settling current and future transactions, central banks, speculators, and individuals. The daily transaction volume of the currency markets is estimated at around $5 trillion, 25 times bigger than the approximately $200 billion[4] daily trading volume of global equity markets.

Global Bonds

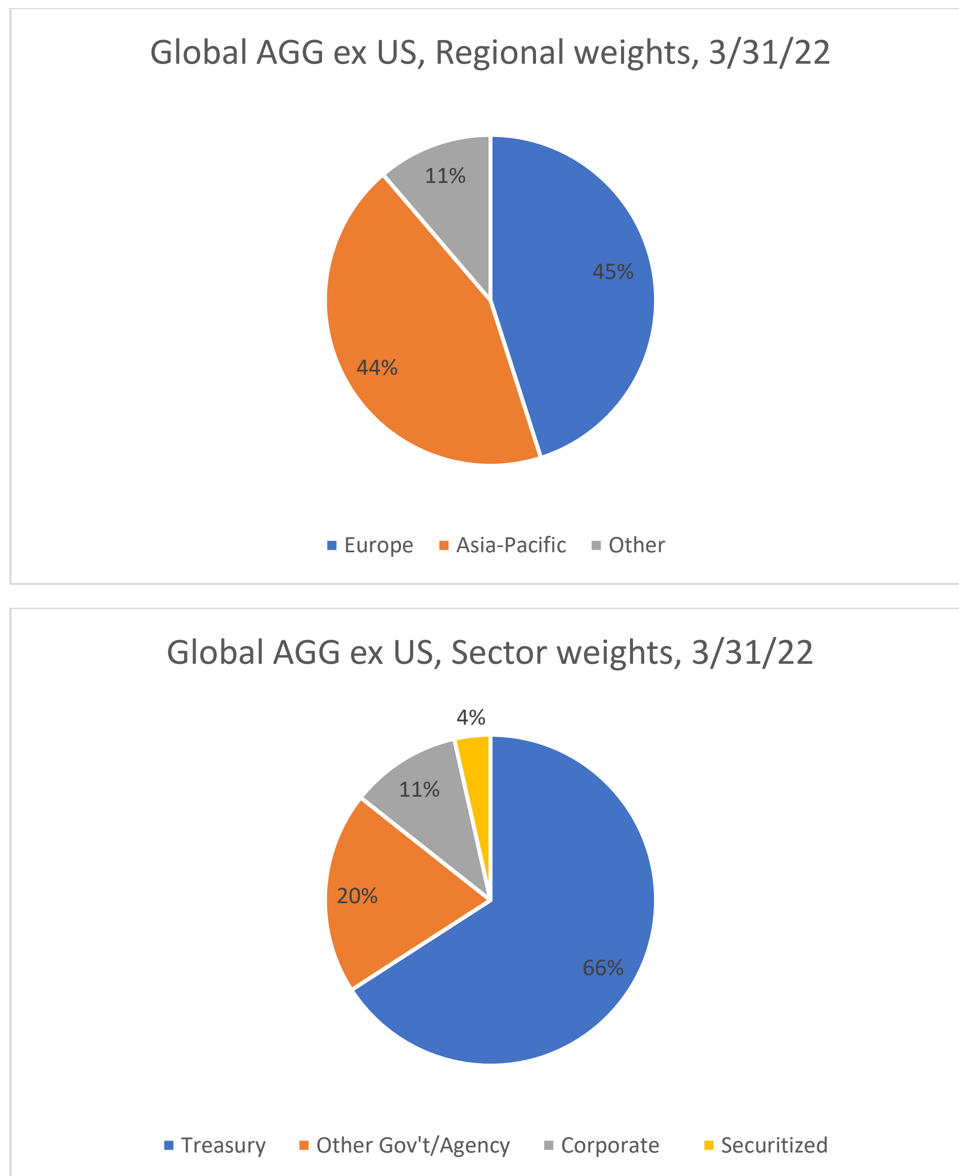
There are also investment opportunities in bond markets worldwide. These include government or government-related bonds and corporate and asset-backed securities. For a domestic investor in US bonds, the primary risks are credit and interest rate risk. Investing in bonds outside the US typically also involves currency risk. While some of these bonds are issued and denominated in US dollars, many are issued in the local currency, so investors are exposed to currency fluctuations and local interest rate risk. This may be of particular concern to investors who have specific US-dollar liabilities to meet (such as

[4] Source: Dailyfx.com, 3/8/2022

insurance companies and some pension funds), and this may constrain their appetite for international securities.

The Bloomberg Global Aggregate ("AGG") Bond Index is a broad representation of global bond markets. The US is the largest single market (38% of that index). In Figure 1-3, we look at the Global AGG ex-US Bond Index and see that Asia-Pacific and Europe are the two major regions—in roughly equal proportions. Treasuries and other Government-related issues dominate the weightings with combined corporate and securitized issues accounting for just 15% of the index.

Fig 1-3 Split of Global AGG ex US Bond Index by Region and Sectors



Source: Bloomberg, 3/31/2022

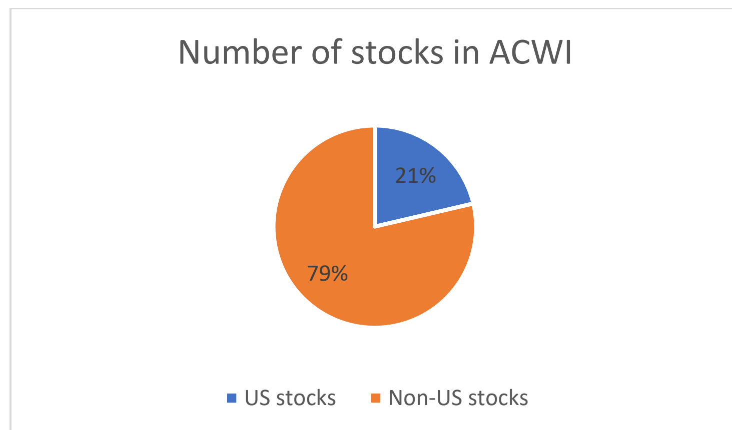
Section 2 Why Invest Internationally?

<u>Equity</u>

The simple answer is to broaden the opportunity set. Logically, the more securities from which an investor can choose, the more chances there are to find ones that can deliver superior returns. This assumes the investor can/will carry out the analysis required.

Even though the US dominates the world markets in terms of capitalization, there are almost four times as many stocks outside the US. This is partly driven by the high weighting of the very biggest US stocks. As an example, the top weighted stock in the US index had an index weight of 7% (3/31/22). You'd need to add up the weights of the top six stocks in the ACWI ex-US index to exceed that number.

Figure 2-1 US vs International split, by number of companies



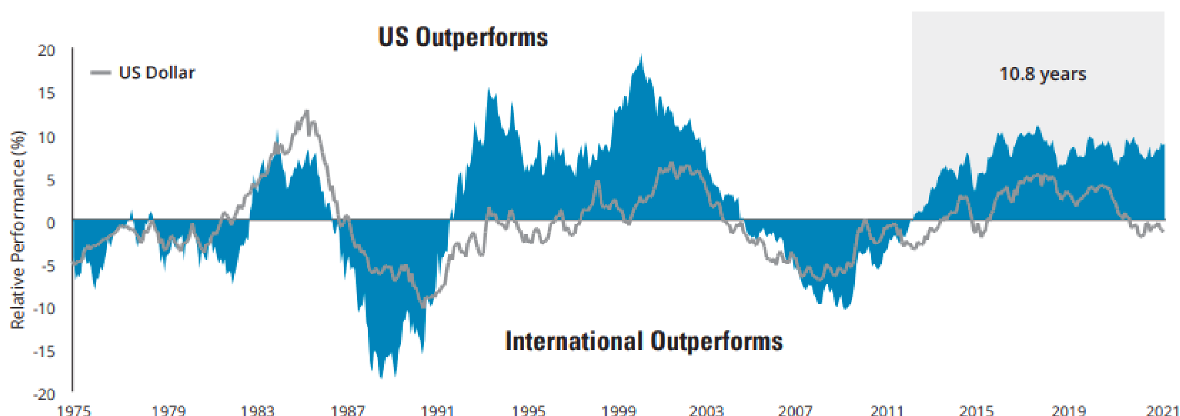
Source: MSCI, 3/31/22

As well as the sheer size of the opportunity set, other arguments have contributed to the rationale for non-US investing:

- Higher growth: other regions of the world may offer faster economic growth than the US, either structurally, or at times cyclically. Note that high economic growth in a region may not translate directly into strong equity performance, but the identification of higher growth segments of the world markets supports the argument for broadening the opportunity set.
- Lower efficiency: The return argument is that non-US markets are less efficient than the US and therefore offer more opportunity to fundamental, analytical investors. The risk corollary of this argues that data in non-US markets is less available and less reliable than in the US. While both of these points may still be true, the globalization of markets and adoption of worldwide accounting and reporting practices mean these aspects may be less powerful than in the past. Nevertheless, diligent fundamental investors may still find significant opportunities outside the mature and efficient US market.
- Passive exposure: the growth in passive investing is driven by investors who are not seeking to "beat the markets," but are aiming merely to participate in the available opportunities. As we've shown, the majority of available opportunities are outside the US, and it is logical that a passive investor might participate in these.

Figure 2-2 US and International Markets Have Moved in Cycles

US Equity vs. International Equity 5-Year Monthly Rolling Returns (1/31/1975-12/31/2021)



The chart shows the values of the S&P 500 Index's return minus the MSCI World ex USA Index's return. When the line is above 0, US stocks outperformed international stocks. When the line is below 0, international stocks outperformed US stocks.

Source: Hartford Funds (including input from Morningstar and Bloomberg). US equity is represented by the S&P 500 Index, International equity is represented by MSCI World ex-US Index. Permission for educational use only granted by Hartford Funds.

Underlying all of these reasons is the recognition that one's domestic market will not usually be the best-performing, and from time-to-time may be below the world average. And like many aspects of investing, this is not easy to anticipate. Diversification to other countries around the world seems a sensible option.

And diversification is not only an intuitive benefit of global investing; it provides mathematical risk reduction. Because world markets are not perfectly correlated, combining a domestic portfolio with a diversified international one reduces the volatility of the combined portfolio (even if the individual markets that make up the international segment are more volatile than the domestic market). This has been heralded as the "free lunch" of international investing (i.e., regardless of whether the international segment outperforms, it always acts as a diversifying, risk-reduction mechanism). With globalization, the correlation of markets has increased over time, but it's likely the free lunch still exists (albeit in a "lower-calorie" format!).

Fixed income

The arguments for international equity are, broadly speaking, expanding the opportunity set and diversification; these apply also to international fixed income as an asset class. However, the characteristics of fixed income mean they are typically applied in different contexts.

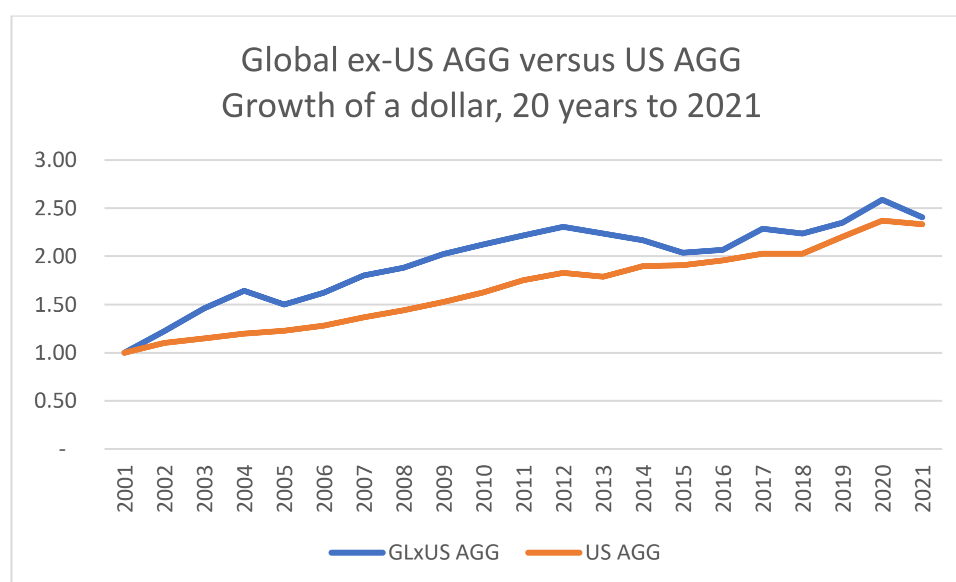
The investor's perspective is important. Is the rationale to diversify a domestic bond portfolio? If so, then creating an integrated global bond portfolio is often the approach chosen, as world economic conditions, including short- and long-term interest rates, inflation and currency all tend to be driven by global factors. Many leading bond managers have global expertise for this reason. On the other hand, if the investor is seeking to add a fixed income component to complement an existing international equity portfolio, then a non-US only fixed approach may be the choice.

In the short term, significant return differences between domestic and international bond portfolios are often the result of currency moves. For a US investor, the key question is dollar performance against a basket of other currencies. Currency is considered in more detail later in this chapter.

Fig 2-4 illustrates that while currency may have a significant short-term impact on relative returns of International versus US fixed income, over longer periods, the differences in the two series have tended to even out.

For those investors seeking opportunities in security selection, the segments of the international fixed income markets to examine include the corporate bond sector (particularly in Europe), including high yield and emerging market (EM) bonds. EM bonds have grown in popularity over recent decades and are addressed in more detail later in this chapter. Other areas of the world bond market that have attracted interest from US investors include, for example, convertibles and distressed bonds, but we do not address these in detail here.

Fig 2-4 International vs US bond returns, 20 years to 2021



Source: Bloomberg, December 31, 2021

Section 3 Investor Perspectives: Global versus International and Home Country Bias

Investors typically learn about, and invest in, their home market first. This is a natural consequence of comfort level, local knowledge, and the easy availability of information. Going outside that local market then requires tackling both analytical and psychological issues. The analytical issues such as where, why, and how to access international markets are addressed elsewhere in this chapter. Psychological issues are more subtle, including whether investors perceive themselves as truly global in perspective, or just look at non-domestic markets as an "optional extra" in their portfolio. One aspect where analytical and psychological aspects intersect is "home country bias," the preference of investors to overweight their local market.

Global versus International Equity

As we explained earlier in the chapter, a global portfolio includes *all* world markets. For a US-based investor, the US is typically the largest segment of a global portfolio. An international portfolio excludes the domestic market. (Note that for a US-based investor, the often-used EAFE Index excludes Canada, as well as the US).

Behind these straightforward definitions are nuances that reflect differing mindsets in approaching worldwide investing. Initial steps toward diversification typically use a non-domestic portfolio as an add-on to the existing, more substantial domestic one. That was the case in the US when international diversification started to become popular in the 1980s. Figure 3-1 shows that International mandates were the overwhelmingly preferred option among US institutions until relatively recently. Substantial growth in Global mandates has occurred in the past 15 years, but even with that, the aggregate Global total was still less than International by end 2021. So, we can still assert that International remains the preferred option, just not "overwhelmingly so."

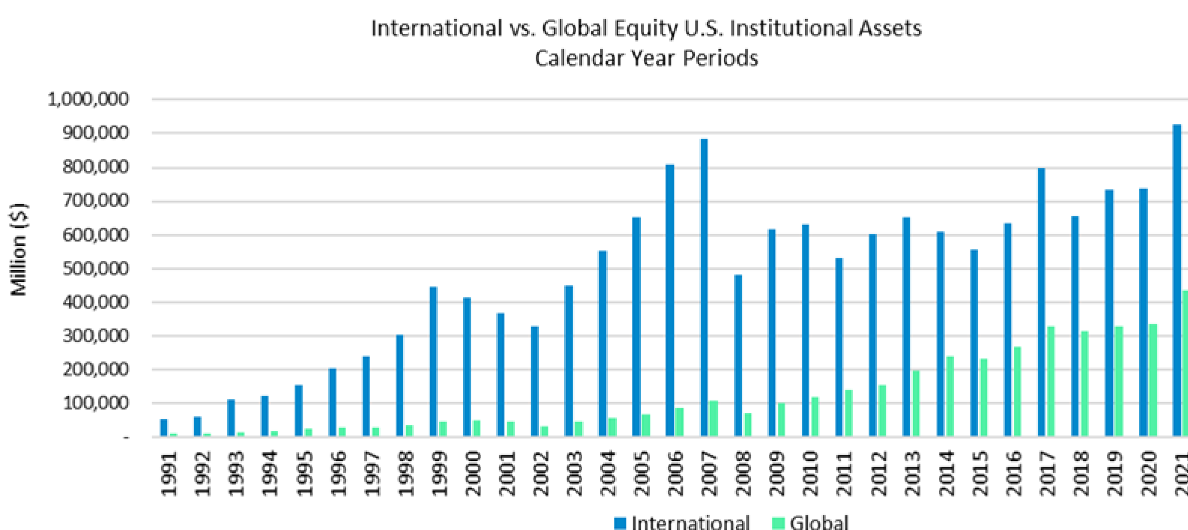
We believe that the increase in relative popularity of Global mandates in the US may have (at least) three underlying reasons:

1. Mindset: As an investor's international exposure grows larger as a percentage of the total, a global portfolio may be more appealing; rather than have a separate non-domestic segment, an investor may treat the domestic market as one of a range of possibilities within a global context.
2. Capabilities: Domestic-based managers (with which investors may be more comfortable) may have developed credible capabilities to manage a truly global portfolio. With that credibility, investors' confidence increases that their mangers will do a better job of deciding allocations between domestic and international (rather than the investors making that choice).
3. In recent years, the Global benchmark has outperformed the International one, primarily due to US market performance. So the past decades' increase in assets in Global mandates must reflect that superior performance, and there may also be an additional impact from investors "chasing performance" by switching more assets to Global. (We make no comment here on the merits of "performance chasing"!)

Note that in smaller markets, global mandates are typically much more common. In countries like Switzerland and the Netherlands (for example) that are globally-oriented by the nature of their small size, and the importance of international trade to their economies, a global mindset is much more

common than in larger economies such as the US or Japan, where historically many investors have found (or still find) it feasible to ignore the rest of the world.

Figure 3-1 Actively Managed International and Global Equity Assets for US Institutions (1991-2021)



Source: Investment Metrics, May 2022

<u>Home Country Bias</u>

One of the most important decisions an investor makes is geographic asset exposure. (This can be a "top-down" decision to allocate to specific regions or countries or "bottom-up," security-by-security decisions that result in those geographic exposures. Either way, the arguments in this section still apply). The more "bias" that creeps into those decisions, the less effective they are likely to be in the long term.

Home Country Bias is the tendency of investors to prefer their home market to a greater extent than is rational. However, note that not all decisions to have a high exposure to the home market are irrational.

For this discussion, we are considering an investor's home country weighting in a global context, so that whether they have a truly global portfolio or separate domestic and non-domestic portfolios is immaterial.

There are four principal analytical (rational) aspects in that home market weighting decision:

1. How large is the home market (e.g., weight in the global index)? A US-based investor with over half of a global portfolio in the US may just be reflecting the passive weight of the US in the world index. An Australian investor with over half in Australian securities does not have the same rationale.
2. Has the investor made a decision (top-down or bottom-up) on analytical investment grounds to over- or under-weight their home market? (Some may argue that there can be bias in this analysis, but we consider this a second-order effect, suitable for discussion in an advanced class!).
3. Are there trading, liquidity or access constraints that prevent the investor from including some or all non-domestic markets?

4. Does the investor (or investor's manager) have the capability to invest in non-domestic markets?

Once these are all taken into account, any substantial overweighting of the home market can be attributed to Home Country Bias (i.e., not justified by rational decisions). Note that the constraints in aspects 3 and 4 generally have declined over the years as markets have globalized, although there are sporadic periods or regions where they may again increase sharply.

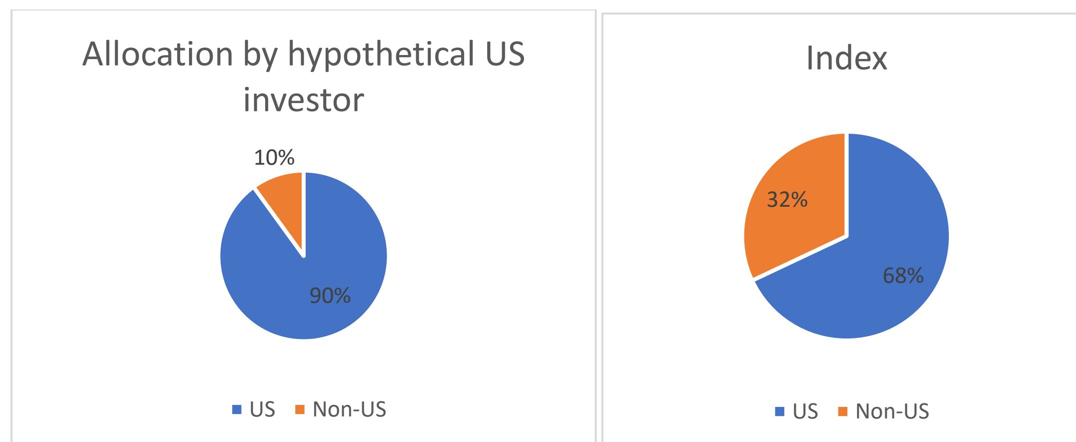
Other behavioral biases may impact the home country exposure. For example, if the home market has outperformed others for an extended period, not only will its weight in the global index have increased, but recency bias and herding may lead many investors to overweight that market further. The US equity market in the decade to 2021 is a good example of this. This bias would apply to all investors—not just those in that country.

The purpose of this discussion is to make investors aware of Home Country Bias and the effect it may be having on their decisions; the first step to countering a bias is to be aware that it exists.

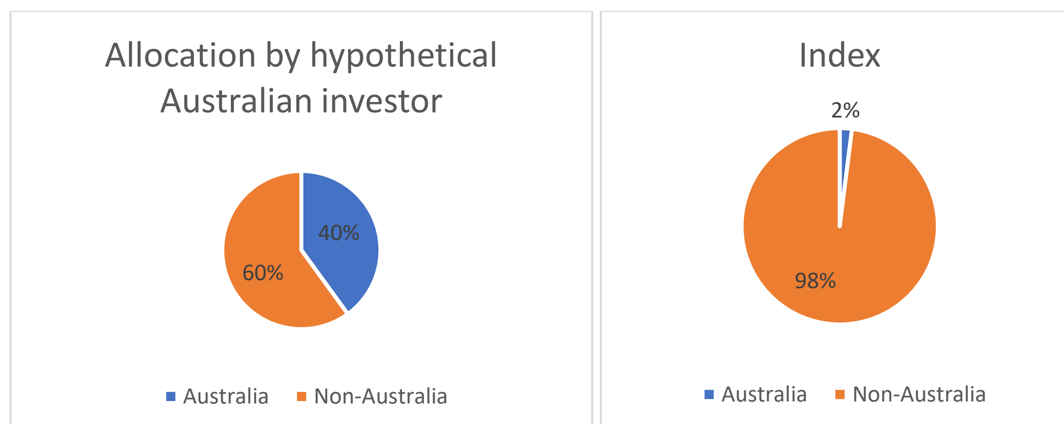
In practical terms, we should not be concerned or debate over differences of a few percentage points. It's when the differences are egregious that Home Country Bias may be damaging for an investment strategy.

Fig 3-3: Examples of Home Country Bias

For US investors, with their home country as the majority of the world market, an even higher percentage allocation to the US is required to show Home Country Bias.



For an Australian investor, any weight in double digits likely suggests Home Country Bias



Source: MSCI World Index weights as of 2/28/22

It's also worth noting a related effect that's not usually researched or documented: Foreign Country Bias. Specialist global (or international) investment managers spend a lot of their time and effort convincing their clients and colleagues of the benefits of international investing. Whether it's because of their own beliefs or to avoid undermining their sales pitch, we have observed a tendency for them to underweight their domestic market (hence "Foreign Country Bias").

Exercise 3-A

	Weight (%)	5-yr ann. Perf (%)	P/E	P/BV	Div. yield (%)
USA	68	15.3	22.9	4.5	1.4
Non-US (EAFE)	32	7.2	15.9	1.8	2.9
Japan	6	6.5	14.5	1.4	2.4
Non-Japan (Kokusai)	94	13.2	20.7	3.4	1.8
UK	4	5.9	15.9	1.9	3.7
Non-UK	96	13.0	20.4	3.2	1.8

Source: MSCI World Index as of 2/28/22

(1) For a domestic investor in each of these countries (US, Japan and UK), above what percentage weight would you consider the investor to be showing home country bias? (Discuss and justify.)
(2) For your own home country, what percentage over or under-weight would you allocate in a global portfolio? Discuss to what extent that is a) justified by future expectations b) justified by structural reasons c) an opportunity for mean reversion d) home country bias. (If this table is significantly outdated, you can update these numbers using data available from the latest factsheets at msci.com)

Section 4 History of Global Investing

As the US economy and securities markets grew in the nineteenth and twentieth centuries to become the largest in the world, the range of investment opportunities "at home" led to US investors becoming increasingly domestically focused. Given the size of the US market, this domestic focus was more pronounced in the US than in most smaller, developed countries.

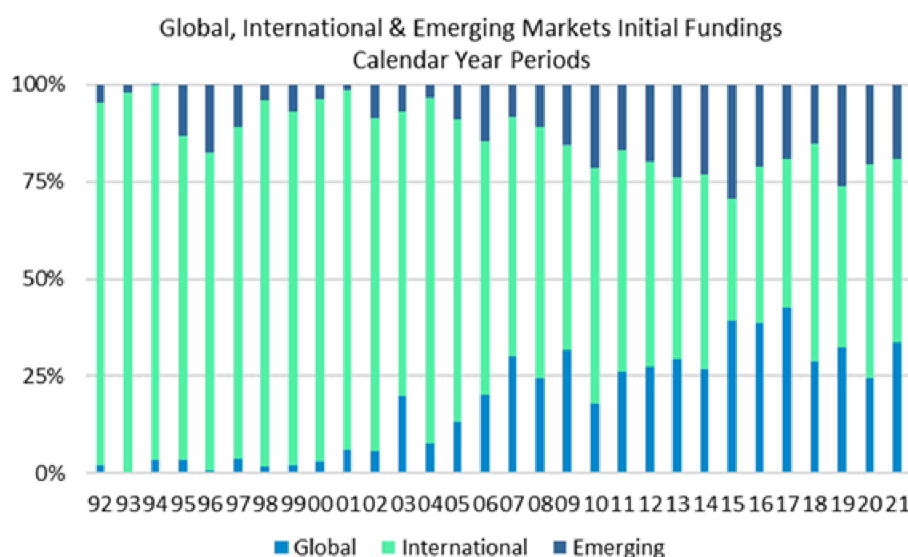
While the development history of modern securities exchanges worldwide is beyond the scope of this Chapter, for those interested in more background, we would recommend the work of Dimson, Marsh and Staunton. These authors wrote "Triumph of the Optimists" (2002, Princeton University Press), which provides over a century of data on stock and bond investing around the world.

From a US perspective, involvement in international investing reached a nadir after the introduction of the Interest Equalization Tax in 1963, designed specifically to penalize foreign investing, with the goal of improving the US Balance of Payments. In 1974, the removal of this tax, along with the passage of ERISA[5] legislation, paved the way toward today's widespread use of international investing by both US individuals and institutions.

As an illustration, by the late 1970s, US institutional investors (led by pension funds) had allocated a total of barely $1 billion to international equity mandates. This was at a time when US stocks represented around half of global market capitalization as measured by the MSCI World Index. They had minimal commitments to non-US bonds. By the end of 2021, counting global, international and EM mandates, US institutions had over $2.5 *trillion* invested in overseas equity and around $0.4 trillion in overseas bonds.

The equity emphasis has gradually shifted from purely international mandates and is now spread more evenly, including global and EM as well.

Fig 4-1 US Institutional Assets, initial fundings by mandate



[5] The Employee Retirement Income Security Act of 1974

Source: Investment Metrics, May 2022

The progression has not been uniform in the decades since 1974. Initially the move toward international diversification was supported by a weak US dollar, boosting overseas returns. When combined with good market returns, this could produce sparkling performance. The EAFE Index surged by more than 50% in both 1985 and 1986 and continued to perform well for the balance of that decade, despite a recovery in the dollar. EAFE's performance was helped by the surge in Japanese stock prices, which peaked in 1989, pushing Japan's weight in the MSCI World Index close to 45% and the US weight briefly under 30%. The subsequent bear market in Japanese stocks lasted 20 years.

Interest in non-US markets continued to grow during the 1990s, albeit dampened by the ongoing slide in Japanese stocks. Toward the end of that decade, investor focus was once again on the US and the so-called "tech bubble." The subsequent bear market in the early 2000s, followed by the "Great Financial Crisis" of 2008-9 moderated returns for both international and US stocks in the first decade of this century. But the subsequent decade (to 2020) saw the US market outpace most other major markets worldwide, driven substantially by very large tech-related growth companies. By the end of March 2022, the US share of the MSCI World Index, at 69%, was at its highest since the 1974 repeal of the Interest Equalization Tax paved the way for the current era of international diversification.

The recent dominance of US equities has moderated incremental demand for international equity investments. At the time of writing, trailing returns of non-US stock indices lag substantially behind those of US indices. As a result, US-based investors maintaining or increasing their international exposure tend either to be contrarians (often value investors, given the strong growth tilt to the large-cap US indices), or investors who have adopted a true global approach to their whole portfolio, in which international equities are always a significant part.

Section 5 Emerging Markets

The term Emerging Markets (“EM”) originated in the early 1980s, coined to describe the less-developed and (mostly) fast-growing stock markets of countries outside the roster of developed nations with more established exchanges. The argument for EM investing was an extension of the one used for global investing: the opportunity to access potentially higher returns for investors who would accept higher risk (not just market measures such as volatility, but also political and social risks).

In the 1990s, the EM concept broadened, with the introduction of a second tier of EM: Frontier Markets (“FM”), countries with investable stock markets that were not yet developed enough in terms of size, access, liquidity or structure to qualify as Emerging. As of March 2022, based on MSCI definitions, there were 24 EM countries and 28 in FM.

However, the concept of investing in less-developed regions of the world is as old as global investing. It’s worth bearing in mind that the US itself could have been considered an “emerging market” in the eighteenth and nineteenth centuries, before rising to prominence as the largest developed market in the twentieth century.

Because they are “emerging,” hence changing relatively rapidly, the list of countries and their weightings in the EM and FM indices varies over time, much more so than for developed countries. Based on investment, political and economic criteria, index providers may promote markets to a higher tier. Occasionally, they may also be relegated to a lower tier, or even dropped or suspended if a market becomes uninvestable (e.g., Russia in 2022). Investors who take a passive approach with EM or FM should at least be aware of their exposure to the underlying countries, industries, and stock concentration, as these vary over time and they may periodically provide unexpected or undiversified risk exposures.

Fig 5-1 Largest EM country weights, 2002 vs 2022

EM as a percentage of ACWI:

4% in 2002

Largest Emerging Markets 2022

37%
22%
14%
13%
8%
7%

Other, S Korea, S Africa, Taiwan, Mexico, Brazil

11% in 2022

Largest Emerging Markets 2022

22%
30%
16%
13%
13%
6%

Other, China, Taiwan, India, S Korea, Brazil

Source: MSCI data as of 3/31/22; MSCI Barra 2008, An Emerging Markets Perspective

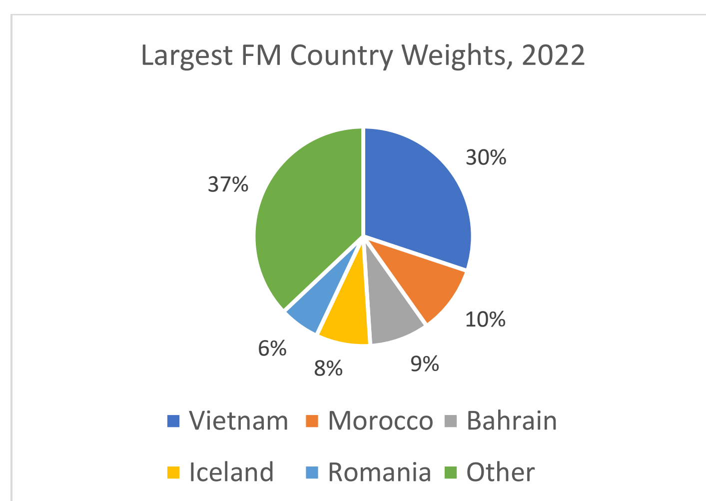
The weight of EM in the MSCI ACWI has increased over the years. The EM index was launched in 1988, with 10 countries and a weight of under 1% in ACWI. That weighting passed 5% in the early 1990s and then dropped again as EM investing suffered through crisis years in the late 1990s. By 2002, the EM weight in ACWI was back to 4%, but then recovered throughout that decade to reach 12%. It has fluctuated around that level since then. Within that weight however, there have been significant changes, the most important being the increasing dominance of China, which now represents 30% of the EM Index.

Any SMIF considering FM investing is likely to be forced to use a passive approach as stocks in these countries are unlikely to be available through their trading platform. They should therefore be aware of the significant changes that can occur in country (and possibly sector) weights when a large market (in FM terms) gets promoted to EM (or vice versa). The total capitalization of the FM index is approximately 1% of the EM index.

Fig 5-2: Largest Frontier Markets, 2022

FM as a percentage of EM:

1.3%



Source: MSCI data as of 3/31/22

Emerging markets have tended to perform in long cycles relative to developed markets. Steady outperformance in the 1980s to mid-90s established EM as an allocation choice for investors. But a series of currency, market and economic crises reversed that trend for the next five years. This century we’ve seen one strong decade (2001-2010) followed by a weaker one.

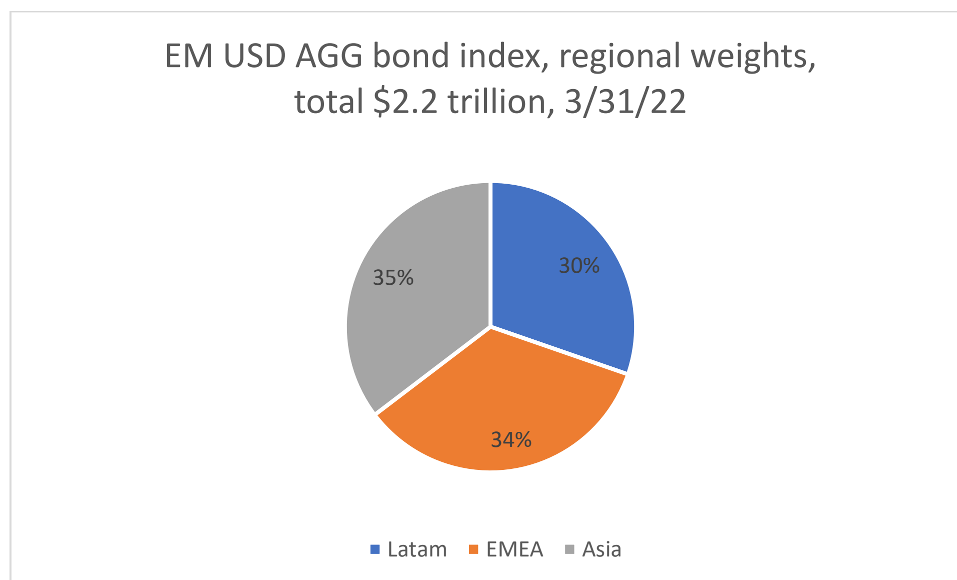
Fig 5-3 Emerging Market equity performance relative to Developed Markets

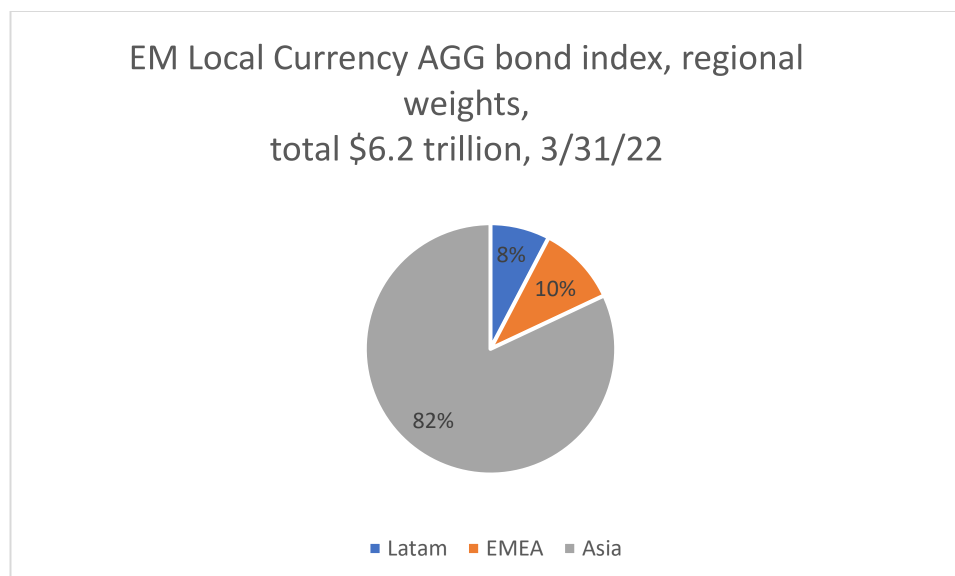
Source: longtermtrends.net https://www.longtermtrends.net/emerging-vs-developed-markets/ , 1988-2022, as of 4/28/22; ratio EM/DM is MSCI EM index/MSCI World index

Alongside equities, emerging market bonds ("EMB") have grown to become a credible possibility for investors looking for opportunities worldwide. The EMB market began in the 1980s when the US Treasury set up a program to help refinance the debt of Latin American governments through issuance of US dollar denominated bonds (named Brady Bonds after the then US Treasury Secretary Nicholas Brady). Eventually these issuers were joined by governments and agencies as well as corporate issuers from around the world. Many of these bonds were issued in US dollars, but some were in local currencies.

The primary attraction for investors has been the higher yield these bonds commanded (especially if they were denominated in local currency). Since EMBs first appeared in the 1980s, US bond yields had been in a broad downtrend, increasing the demand for the higher EMB yields. In addition, corporate credit spreads have generally narrowed over that extended period, providing a historical return boost for investors in corporate EMBs. Occasionally, corporate issuers commanded a higher credit rating than the country in which they were located. EMB risks include interest rate and credit risks, as for any bond, but also potentially significant political and (for local currency bonds), currency risk.

Fig 5-4 EM bond markets





Source: Bloomberg, 3/31/22

The EM bond market includes both US dollar and local currency bonds, shown separately in Fig 5-4. Chinese bonds are a significant part of the EM bond universe, particularly in the local currency segment where they account for 41% of the total (about half of the Asia weight shown in that chart).

For a SMIF interested in EMB, the most suitable vehicles are mutual funds and ETFs, which are now both reasonably available in the US across a variety of EM bond strategies.

Fig 5-5 Emerging Market bond funds (US-registered)

	AUM ($bn)	Number of funds
Mutual funds	57.1	71
ETFs	27.9	24

Source: Morningstar for Mutual Funds, 5/2/22; ETFs https://etfdb.com/etfdb-category/emerging-markets-bonds/ , data as of 4/14/22

Exercise 5-A

To illustrate the degree to which investors are stepping into the unknown when delving into international markets, especially EM and, in particular Frontier Markets, we invite SMIF participants to try the following task:

Without looking it up, write down as many companies as you can that you think are in the top ten by market capitalization of:

- The US
- EAFE
- Emerging Markets
- Frontier Markets

Now look up the answers, doing an internet search for MSCI Index (*insert index name*) Factsheet

For US readers, you may have listed a majority of the US top ten, but you're doing well if you got more than three each of EAFE and EM, and award yourself a gold star if you knew any of the Frontier Market top ten companies.

Look at the correct "top ten" in the MSCI Factsheets for EAFE, EM and FM. How many company names are at all familiar to you? The point of this exercise is not to cause you to be nervous about the unfamiliarity, but to illustrate that (a) you (and others) may miss many opportunities internationally due to failure even to look, and (b) you should be prepared to apply more rigorous analysis internationally to overcome this lack of familiarity. We believe the benefits will be worth the effort.

After completing this exercise, if you want to feel better about your own level of knowledge, find an experienced investment professional (who doesn't specialize in EM) and ask politely if they can tell you the top five countries by market cap in the Frontier Market index. When he/she dances around the question without giving you an answer, follow up (equally politely) with "That's OK. Actually, I only need to know the name of one of the top five. Could you help me with that please?" (PS: do not try this at an interview for an investment job.)

Section 6 Philosophy and style

The widespread global practice of articulating an investor's philosophy and style is a relatively modern phenomenon, dating back to the emergence in the 1980s of the investment consulting industry, providing financial advice to large asset owners such as pension funds or endowments.

In the US, value investing was pioneered by Benjamin Graham in the 1930s, and gradually gained adherents over the years. Growth investing became popular in the 1960s, and the "growth vs value" debate has occupied investors' minds ever since.

There were a select few US-based investors who were researching *international* opportunities prior to the late 1970s, notably value stock-pickers John Templeton and Charles Brandes. However most global investors in that era were European-based, and their prevalent approach could be described as a top-down/bottom-up combination, with what is now described as "Growth at a Reasonable Price" or GARP as the style.

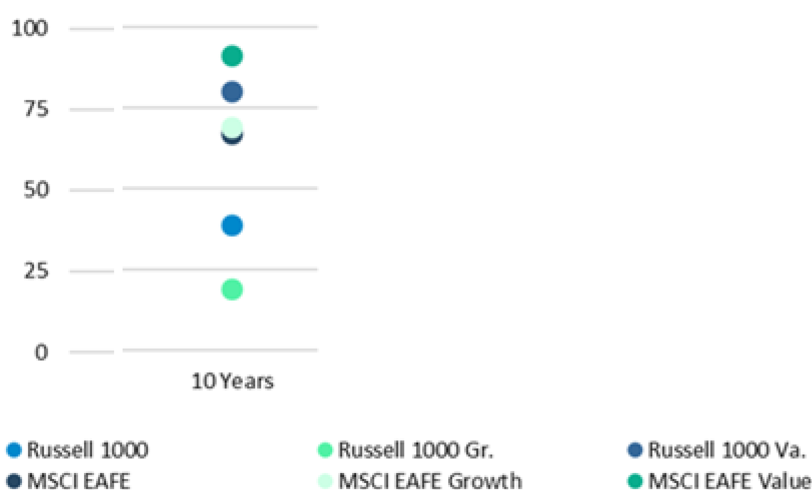
Throughout the 1980s, US interest in overseas markets grew rapidly, and with the increasing importance of the US consulting community in placing assets, investors worldwide adopted the terminology already used widely in the US. US-based international managers spanned the range from value, through core, to growth, and their overseas-based counterparts gradually evolved from a general GARP approach to include a similar range of styles. Quantitative and index approaches originated in the US, but have been widely adopted globally, so the range of philosophies, styles and disciplines in the investment industry today are in worldwide usage.

Regardless of style, a key issue facing international investors (as opposed to domestic) is how to incorporate the country/region decision. Some are top-down: making country/region allocations first, and then picking securities within each country/region. Others favor bottom-up: deciding on securities on a global basis, and letting those selections determine the exposure to countries and regions. Note that for equity investors, there are many adherents of each approach (or a combination thereof), especially as domestic investors are naturally bottom-up, and hence may be comfortable using this

approach worldwide. For global bond investors, the top-down approach is prevalent, other than for a small number of bond investors focusing on credit analysis rather than currency and yield management.

While the merits and uses of Active vs Passive and Value vs Growth are debated worldwide, the global perspective has invited discussion on the relative inefficiencies of non-US markets versus the US, and whether this provides more opportunities for the worldwide investor.

Fig 6-1 Benchmark Percentile Ranking vs Active Large-Cap Manager Peer Groups, 10 Years to 2021



Source: Investment Metrics, May 2022

The US equity market is generally held to be difficult for active managers. This has been exacerbated in recent years by the concentration of high-performance large growth stocks that US indices such as the S&P 500 Index or Nasdaq Composite. In the US growth peer group, the benchmark index has ranked in the top quartile (0-25%) by performance. The US value peer group has done better, at least relative to its benchmark, which ranks in the fourth quartile (75-100%) of the peer group (see Figure 6-1). Across value and growth styles, according to Investment Metrics, only 40% of US active large-cap managers beat their benchmark in the decade to 2021.

International markets are thought to be less efficient than the US and this suggests that active management has a better chance to pay off outside the US. Even though the past decade saw strong outperformance by growth indices, relative to value, active management generally worked, relative to the respective style indices. Based on Investment Metrics data, nearly 70% of active *international* managers beat their style benchmark over that decade, with value managers doing better than their growth counterparts in that context. Note in Figure 6-1 that the MSCI EAFE *Value* Index was the deepest in the fourth quartile, suggesting that active, value managers in non-US markets tended to outperform the EAFE Index.

Section 7: Analysis and Accounting outside the US

Practical issues facing domestic investors researching foreign securities fall broadly into two categories: information access and accounting differences. Over the years, life has become easier as difficulties are less pronounced, but a serious investor must consider these:

Information Access

- Language (we assume readers to be proficient in English if they are using this textbook): this is no longer an issue. For the vast majority of securities, company accounts and related information are now produced in English.
- Data and research sources: investment databases are generally worldwide in scope; brokerage research reports on securities are generally available for larger companies in the larger world markets. For an investor considering smaller companies and/or smaller, less-developed markets, external research coverage may be thin to non-existent. This may be a problem, but can also be an opportunity to find inefficiently priced opportunities in relatively unexplored territory.
- For institutional investors, the desire to meet and evaluate company management in-person has historically been an expensive and time-consuming aspect of international investing. For student-managed funds, these types of meetings have typically never been a practical part of their programs. Ironically, the increasing use of virtual meetings may even have made this type of information flow practical for SMIFs worldwide for the first time.

In sum, access to information worldwide should no longer pose significant problems. Where the hard work begins is understanding and analyzing that information.

Accounting Outside the US

In sports, all teams play by the same set of rules. Scoring a goal in soccer is the same whether the game is played in Africa, Asia, Europe, or North or South America. There can be disputes over what constitutes a goal and penalties applied to those in the game, but everyone pretty much buys into 95 percent of the process. Keeping score is a lot more confusing in the international investment arena, where many countries have their own set of accounting rules and corporate disclosure practices. And even when the terms are the same, they don't necessarily mean the same thing. But that same confusion creates opportunity for those who understand the differences in global accounting methods.

In the United States, the Financial Accounting Standards Board (FASB) oversees U.S.-based companies' adherence to generally accepted accounting principles (GAAP). Any non-U.S. company that is listed on a U.S. exchange must also satisfy reporting standards that conform to GAAP. Some multinationals fulfill this requirement by issuing two sets of accounting statements, one to meet local standards and a second for purposes of U.S. GAAP. Other companies use a single report and publish results in accordance with their own national accounting requirements. Within the framework of that same report, numbers are converted into U.S. GAAP terms.

Outside the United States, the International Accounting Standards Board (IASB) oversees the adoption of International Financial Reporting Standards (IFRS) by many nations. These standards are now widely accepted, with many countries—most of the European Union, Australia, Canada, New Zealand, Brazil, and Mexico among them—mandating or permitting some or all of their application. A significant number of non-U.S. companies listed on American exchanges use IFRS as well.

The Push for Global Uniformity

In 2002, the IASB and the FASB announced an agreement to work together to combine international and U.S. accounting standards. Two decades later, the process is still underway! In the meantime, IFRS standards have been a big help in developing accounting consistency overseas.

Other reporting rules around the world are not necessarily better or worse than U.S. GAAP; they are just different and, in some cases, more widely used. Financial accounting is a somewhat judgmental process. In addition, accountants often make assumptions about the future that understandably differ from country to country.

Dealing with Differences

Although IFRS has made significant strides abroad, not all countries have adopted it completely as their own universal standard. And, considering the slow-moving convergence with U.S. GAAP, there are some pockets of accounting variations that fundamental investors regularly identify, interpret, and weigh into the equation.

For example, there are nearly 100 rules for documenting sales under GAAP, which can vary by industry. IFRS uses just two. When it comes to earnings, some overseas companies, particularly when reporting extraordinary earnings from sales of subsidiaries or real estate, may report these earnings less conservatively than they would under U.S. GAAP standards.

Investors may find it useful to compare cash flows rather than reported earnings. Although cash flow per share requires adjustment for differing accounting methods, the statistic is generally more comparable than earnings where accounting differences can result in price/earnings (P/E) ratios varying from country to country. But by using price/cash flow multiples, the variation is often reduced and the results become more comparable.

While beyond the scope of this Chapter to go into detail, other accounting practices that may differ from country to country include depreciation, goodwill, asset revaluations, tax provisioning, inventory revaluation, and stock-based compensation accounting.

For any investor, financial statements are a vital element in the decision-making process. However, financial accounting is an inexact discipline at best. Attaching hard numbers to dynamic and perpetually changing business conditions may be a difficult task for most SMIFs. At the very least, however, it’s advisable to be aware of major differences in accounting techniques around the world.

SIDEBAR on GAAP vs IFRS, source: Investopedia

The standards that govern financial reporting and accounting vary from country to country. In the United States, financial reporting practices are set forth by the Financial Accounting Standards Board (FASB) and organized within the framework of the generally accepted accounting principles (GAAP). Generally accepted accounting principles refer to a common set of accepted accounting principles, standards, and procedures that companies and their accountants must follow when they compile their financial statements.

International Financial Reporting Standards (IFRS) are a set of international accounting standards, which state how particular types of transactions and other events should be reported in financial statements. IFRS are issued by the International Accounting Standards Board (IASB), and they specify exactly how accountants must maintain and report their accounts. IFRS was established in order to have a common accounting language, so business and accounts can be understood from company to company and country to country. More than 144 countries around the world have adopted IFRS, which aims to establish a common global language for company accounting affairs.

The primary difference between the two systems is that GAAP is rules-based and IFRS is principles-based. This disconnect manifests itself in specific details and interpretations. Basically, IFRS guidelines provide much less overall detail than GAAP. Consequently, the theoretical framework and principles of the IFRS leave more room for interpretation and may often require lengthy disclosures on financial statements. On the other hand, the consistent and intuitive principles of IFRS are more logically sound and may possibly better represent the economics of business transactions.

Section 8 Currency

The Characteristics of Currency

In the context of international investing, currencies are conceptually distinct from stocks or bonds. The currency market is magnitudes larger than either, given its role as the mechanism for most global trade, not just investment flows. But for investors, the distinct difference is that owning currencies is a zero-sum game.

Stocks and bonds move up and down independently, and at least in theory, can all move up or down at the same time. Currencies, however, are priced against other currencies. An upward move in one must be matched by an equivalent downward move in another. While an equity investment provides exposure to the profits, dividends and growth of the underlying company, owning a currency as an asset can be viewed as pure speculation, a bet on a currency move.

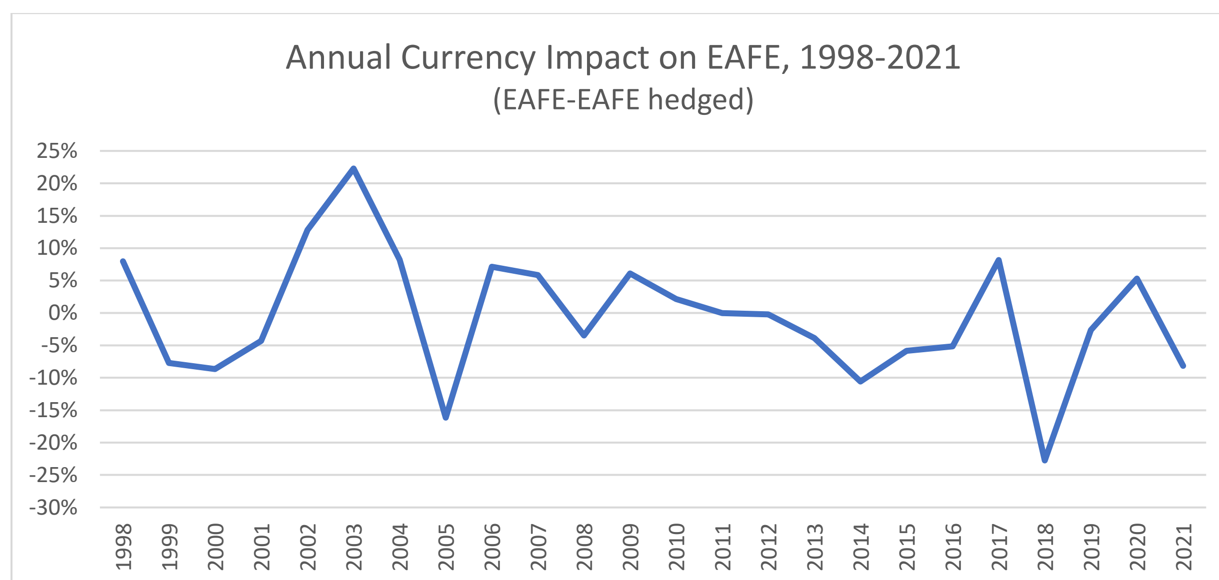
This is one reason why currency is not typically used as a stand-alone asset class by long-term investors, although currencies are actively traded by short-term speculators given the depth and liquidity of that market. As an example, when international bonds were first being considered by US institutions in the late twentieth century, some union and public pension funds resisted on the grounds that such an investment was a bet against the dollar and hence unpatriotic.

Nevertheless, currency ownership is implicit when investing internationally. For example, most international investments by US investors are exposed to currency movements (the main exception being US dollar denominated bonds for non-US issuers). This includes local securities, but also ADRs, ETFs, and mutual funds where the underlying securities are denominated in local currencies.

Over shorter periods, currency moves may be a significant component of overall international returns (positive or negative), but given the cyclical nature of the currency markets (at least for most major developed countries), as the observation period lengthens, the currency impact on returns tends to diminish. This observation is the rationale why many global equity investors do not attempt to manage or hedge currency. Colloquially, “it all tends to come out in the wash in the end!”

Fig 8-1 Currency impact, EAFE vs EAFE hedged 1998-2021

(A positive percentage change is the result of a weak US dollar and a negative change is the result of a strong dollar)



Source: MSCI, EAFE and EAFE hedged annual returns

The pattern of currency impact has been variable over time, with the dollar relatively weak prior to 2010 and stronger in the past decade. However, over the full 24-year period, both the EAFE and the EAFE hedged indices had the same average annual return (5.4% per annum).

The good news for SMIFs, as we've noted elsewhere, is that they do not necessarily have to trade and settle in overseas currencies; all those complexities can be avoided by a domestic trading platform and using ADRs, ETFs and funds. The bad news is that they still need to be aware of currency movements, as these affect the price of their investments on a daily basis.

At the most direct level, a fall in the price of the domestic currency (and we will use the US dollar as our example from here on) implies a rise in foreign currencies, which boosts the value of foreign investments, and vice versa. But reality is more complex. That rise in foreign currencies raises import costs and reduces prices received for foreign-based exporting companies. Their local share prices may decline in response, offsetting any gain a US investor makes on the currency.

In a less direct, but still important way, investors should also be aware that as well as the direct impact on local share prices, the revenues, costs and hence profits of companies are also impacted by currency moves due to the global nature of their business mix. For larger, globally diversified companies these impacts can be especially marked, and hard for investors to anticipate: while some companies disclose the currency breakdown of their revenues, they generally do not disclose the status and progress of their internal currency management (hedging). To put this in context, it is estimated that the proportion of revenues from outside the US for S&P 500 companies has been in the order of 30% over the past few years, as of 2022.

https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/s-p-500-companies-non-us-revenue-share-hits-10-year-low-8211-goldman-sachs-59094991

Currency Hedging

For investors (including SMIFs) that want to remove any currency exposure, hedging may be considered. The most common way of currency hedging involves calculating one's foreign currency exposure for each currency in the portfolio, and then selling that foreign currency amount "forward," typically for delivery in three months' time, at which point the hedge can be closed (by buying back that amount of foreign currency) or extended ("rolled") for another three-month period. The net effect is that if the currency moves against the dollar in that period, the portfolio sees no impact from that move (up or down).

The trading costs of hedging in the currency market are low, but investors must be aware that they also pay (or receive) the three-month interest rate differential between the foreign currency and the dollar. If an investor is hedging exposure in a perceived high-risk currency, that country's interest rates may also be high, aiming to prevent the devaluation that the investor is trying to hedge against. In situations like that, the interest-rate differential cost could be substantial (e.g., 1% per month or more of the exposure being hedged).

In practice, SMIFs are unlikely to hedge a portfolio themselves, for the same reason they will generally not trade and settle in local currency (too complex and time-consuming). But there are a limited number of currency hedged ETFs and mutual funds that invest in international stocks and bonds, so the choice of vehicles for a SMIF that chooses to hedge its foreign currency exposure will be much more limited than for one that does not hedge.

The institutional popularity (and use) of hedging in the US has tended to rise after extended periods of dollar strength (and resulting good performance of hedging programs). Given the cyclical tendency of currency markets, these may be the least productive times to start a hedging program. For SMIFs it may be best to decide philosophically at the outset whether international investments should be unhedged or hedged—and then stick with that decision. It is likely that the worst currency outcomes may be the result of "chop and change" decisions on hedging.

Section 9 Practical Considerations for Student Managed Investment Funds

Expanding the SMIF organizational structure to include a global perspective

Globalizing the SMIF approach requires some additional decisions compared to a purely domestic portfolio:

- The philosophy/style approach to internationalizing is addressed earlier in this chapter. Basically, will the approach be top down (deciding on country allocations first), or bottom-up (focusing on security selection and letting that drive country exposure), or a combination of the two?
- This decision then impacts how personnel resources may be allocated. If a top-down approach is chosen, then it may make sense for one or more individuals to focus on those allocations and security selections. Other than the decision on how much to allocate internationally, they can work independently from the domestic team. However, if the selected approach is bottom-up, then it may make more sense to look at the opportunity set on a global basis, perhaps dividing analytical responsibility by sector.

<u>Trading platforms and instruments</u>

For most SMIFs, the complexities of accessing and trading foreign securities by going directly to local markets is likely to be time-consuming and expensive, as well as cumbersome, requiring the ability to settle in foreign currency and a basic familiarity with local regulatory requirements. Accordingly, the most practical approach is to use the fund's current trading platform—assuming that it can provide access to an acceptable range of foreign securities that trade and settle in the domestic market. Most of the major trading platforms in the US *do* have that capability, as well as availability of mutual funds and ETFs that provide access to international markets.

<u>Taxation</u>

It is not within the scope of this publication to provide tax advice, but SMIF investors should be aware that including an international element to their portfolio may expose them to additional types of tax. The most common of these is withholding tax. Many countries impose withholding taxes at source on dividends and interest paid to non-domestic investors. While certain tax-exempt institutional investors may be able to reclaim some of these amounts, a typical SMIF will not. Note that many index providers calculate international equity indices on a gross and a net basis (before and after withholding tax). For a SMIF, the net index calculation is more relevant.

<u>Depositary Receipts</u>

The number of foreign stocks and bonds that list directly on the domestic exchanges is generally small, around 200 as shown in Figure 9-1. In the same way that many domestic investors prefer to avoid the expense and complexity of going directly to foreign markets, foreign issuers generally don't relish the expense and complexity of listing their securities directly in other countries. First established almost a century ago, the practical solution is the Depositary Receipt. This is a tradeable certificate, typically issued by a custodian bank, that represents ownership of a specified number of underlying shares. The goal is to allow domestic investors to own a security that trades similarly to the underlying, non-domestic equity, and in a form that trades, settles, and can be valued as a domestic security by their trading platform.

The most commonly used in the US is the ADR (American Depositary Receipt), but other variations exist (in the US and around the world) including ADS (American Depositary Share), GDR (Global Depositary receipt), and IDR (International Depositary Receipt). In this context, we refer to ADRs and the US markets, but the properties mentioned below are characteristic of most types of Depositary Receipts.

Detailed information on ADRs is widely available (including on the internet). Around 2500 ADRs are available to US investors (see Fig 9-1) but a large proportion of them may be relatively illiquid. We summarize some key characteristics of ADRs that differentiate them from underlying securities:

- <u>Currency</u>: because ADRs are domestic securities, they trade and settle in dollars, but any price changes in the underlying currency of the issuer are reflected in the ADR price. Hence owning an ADR does NOT insulate the investor from currency movements.
- <u>Sponsorship</u>: ADRs may be created at the initiative of the underlying company; these are called "sponsored" and the issuer is likely aiming to build an investor base in the US and is motivated to provide information to US investors. Some sponsored ADRs are listed on US exchanges, typically those of larger companies prepared to make that substantial commitment. ADRs may

also be created by a custodial bank to meet investor demand, with no involvement or support from the issuer. These are "unsponsored."

- Listing: Some sponsored ADRs are listed, but others, and all unsponsored ADRs, trade "over the counter" or OTC.
- Liquidity: This can best be described as variable. Some ADRs, especially sponsored ADRs, trade actively, but others may only trade intermittently, if at all. Because the pattern of supply and demand for ADRs is driven by US investors (which may be different from that of the local markets), the trading volume of specific ADRs may vary significantly over time, depending on whether it is in or out of favor with US investors.
- Taxes and fees: Associated with the convenience for US investors is the added cost compared to owning local securities. The custodian banks charge fees for their services, which are priced into the ADRs, along with currency costs and any other related transaction fees or taxes.

Fig 9-1 Number of foreign stocks available to US investors

	Europe	Asia Developed	Asia EM	Other EM
Primary listing on a US exchange	55	6	5	7
Secondary listing on a US exchange	94	26	11	5
ADR on US exchange	125	29	201	113
ADR OTC	811	684	284	211

Notes: Secondary listing are companies that have primary listing on non-US exchanges, but "cross-list" in the US. US exchange listings include only non-Canadian companies with market capitalization over USD 1 billion as of May 12, 2022

Source: Citibank, StockmarketMBA

Securities, Funds and ETFs

Some of these limitations on access to specific securities can be at least partially addressed by using domestically registered ETFs or mutual funds to achieve the international exposure needed.

Most international ETFs provide passive exposure to regions, countries, sectors or themes, and do so at a relatively low cost compared to equivalent mutual funds. While mutual funds also provide passive exposure to international markets, their edge over ETFs in a global context is the wide range of *active* international strategies offered via mutual funds.

For a domestic-only SMIF, ETFs and mutual funds are essentially supplementary: for a portfolio team that prefers not to make its own security picks, this is a more costly, but practical alternative. Internationally, these commingled vehicles are not just an alternative way to proceed. In fact, they may be the only practical way to achieve exposure to segments of the world markets that are difficult to reach using only ADRs.

ETFs and mutual funds may also offer a very practical way to gain exposure to the world's bond markets, where most SMIF investors may be more focused on gaining exposure to currency and interest rate moves than identifying specific mis-priced securities.

Portfolio Accounting and Performance Measurement

For a SMIF making a material investment in international markets, we've suggested that for practical reasons, the trading, settlement and accounting should be done using a domestic platform. This brings

many advantages, but one significant disadvantage of using a domestic platform is the loss of analytical information when all reporting is in a single country/currency format, and often measured against a domestic index.

SMIF investors may want to know whether performance is due to good security selection, or choice of country/region? To what extent did currency moves impact returns? And at the most basic level, how did their international segment perform relative to the appropriate international index?

This leads to a clear "either-or" decision for most SMIF investors. If the non-domestic part of their program is not deemed significant, then they may choose to live within the limitations of using a domestic-only reporting package.

If however, it is deemed to be of significance, then it is possible to develop internally a spreadsheet analysis that breaks down ("tags") securities by region, country, currency, and sector. This can then be maintained for portfolio changes (trades, mergers, splits, etc.), and thus can be repriced periodically (monthly or quarterly) and measured against the relevant international indices and currency changes. Essentially SMIF management is creating a parallel reporting/analytical tool alongside the reporting package provided by the domestic platform.

This will involve significant work, in both creation and ongoing management. Note that it will not be an exact accounting to reconcile with the domestic system, as security and currency prices may differ (by source and time of day), and smaller items such as dividends or fees are unlikely to be included. Nevertheless, such an endeavor brings two major benefits to the SMIF: a much better appreciation of how the international markets work, and a better understanding of the significant factors impacting the absolute and relative return of the international segment of the portfolio.

Section 10 A Value Investor's Perspective

Charles Brandes has been a global value investor for almost 50 years, having founded Brandes Investment Partners in 1974. For SMIFs interested in applying a value approach to their international investments, his book *Value Investing Today* offers time-tested practical guidance.

We start this section with a quote from that book:

"Graham and Dodd value investing can often be a lonely discipline, especially on the global level, where investors tend to herd to the 'hot dot' countries or regions. Independence is part of the value investor's DNA. In fact, the only way that long-term active value investing can outperform is by separating from the pack. Value investors operate differently; the truly focused ones are distinct from their peers, and their portfolios are often clearly miles away from their benchmark or index.

"The thought process and approach of the value investor and the overall market are completely different, for the most part. We go where the value is, and this usually takes us to places where most investors won't venture, at least for the moment. If everything works the way it should, the party eventually catches up with us because capital will always flow to where the opportunities exist."

Value investing is a straightforward discipline to understand, but can be an extremely difficult one to apply successfully. Not because it demands a detailed understanding of company fundamentals (although it does), but because it requires investors to overcome their own ingrained behavioral tendencies, such as "running with the herd."

In practice, SMIF portfolio construction will likely comprise individual securities, mutual funds, and ETFs, possibly including bonds as well as stocks. With a wide variety of possibilities available globally, there's often a temptation to own a bit of everything. Resist this. Check that not only do the individual holdings or funds still deserve their place, but the overall portfolio is consistent with the stated goals. Successful value investing is not about finding the next "big winner" (that's for growth investors!) but about discipline and patience: consistently comparing price and valuation, and patiently pruning the portfolio. As economist Paul Samuelson famously said, "*Investing should be more like watching paint dry or grass grow.*"

Based on many years of practical value investing experience, here are ten suggestions for SMIFs aiming to apply a value approach successfully to their international (or domestic) programs.

WRITE IT DOWN

1. Value investing is a long-term, multi-year discipline, but SMIF leadership may rotate every year or so. So set clear written objectives, including philosophy, processes and rationales. These will be needed by successor management. One of the biggest drags on performance for institutional funds is when "new management" reverses long-term decisions made by predecessors because they don't understand the rationale.
2. Set down clear decision rights and responsibilities for both individuals or committees.
3. Value decisions may be contrarian, both at the time, and with hindsight. Write down the reasons for any actions taken on the portfolio.

DO YOUR HOMEWORK

4. Get the best global screening database you can find (and afford).
5. Screen for value, but don't rely just on the raw data; follow up by doing the fundamental "homework."
6. Don't throw out the outliers from the screen; some may be errors but others may be opportunities.

BROADEN YOUR HORIZONS: DISTANCE and TIME

7. Go truly global....don't limit the scope just to major markets worldwide.
8. Take a long-term perspective and don't be afraid to make decisions that will carry through to successor leadership (as long as the rationale is documented in writing for them).

UNDERSTAND THAT YOUR BIGGEST ENEMY MAY BE YOURSELF

9. Value investing requires mathematical skills, but successful value investing is a mental discipline.
10. Read as many behavioral finance articles and books as possible.