White Paper | MARCH 2018

NEUBERGER | BERMAN

BENJAMIN SEGAL
Senior Portfolio Manager
Head of Global Equity Team

Active Non-U.S. Equity for an Increasingly Volatile World

More than $17 billion in institutional flows were directed to passive international equity strategies globally in 2017, according to eVestment. This capital came at the expense of active managers, who saw $29 billion in outflows during the year. These numbers perhaps are not totally surprising given recent industrywide trends toward passive investing. Passive investment products across the equity spectrum have attracted investors for reasons ranging from perceived lower costs to a desire to maintain beta exposure in certain asset classes in order to allocate active risk to others.

As we demonstrate in this paper, however, investors who opt for passive exposure to non-U.S. equity markets are not only forgoing the potential to add above-benchmark returns over a full market cycle, they may also be giving up the risk management that historically has buffered investors from the full impact of down markets—a feature that may become particularly impactful to the total returns of international equity portfolios as markets become more volatile and two-way.

Executive Summary

- Investors who opt for passive exposure to non-U.S. equities may be giving up both the potential for above-benchmark returns and the risk management that can help mitigate losses incurred in down markets.
- Active non-U.S. equity strategies have consistently outperformed the MSCI EAFE Index over a variety of time periods since the global financial crisis. A common thread among the outperforming strategies is effective risk management, as evidenced by their attractive downside-capture statistics.
- There are inherent limitations to passive investment portfolios attributable to the method by which equity indexes—and thus the passive strategies that track them—are constructed. These may include static coverage of non-U.S. equity markets and capitalization-weighted exposure to stocks regardless of their profitability or valuation.
- Profitable companies historically have delivered better returns than those that lose money, highlighting the value of an active manager who can look across an expansive investable universe of more than 11 sectors, 21 countries and 3,700 stocks—both in and outside of the benchmark—to seek to identify exploitable mismatches between a stock's valuation and its potential profitability.
- Increased market volatility and bidirectional price movements may usher in a period during which disciplined stock selection and limited downside capture become even more important to the total returns of international equity portfolios.

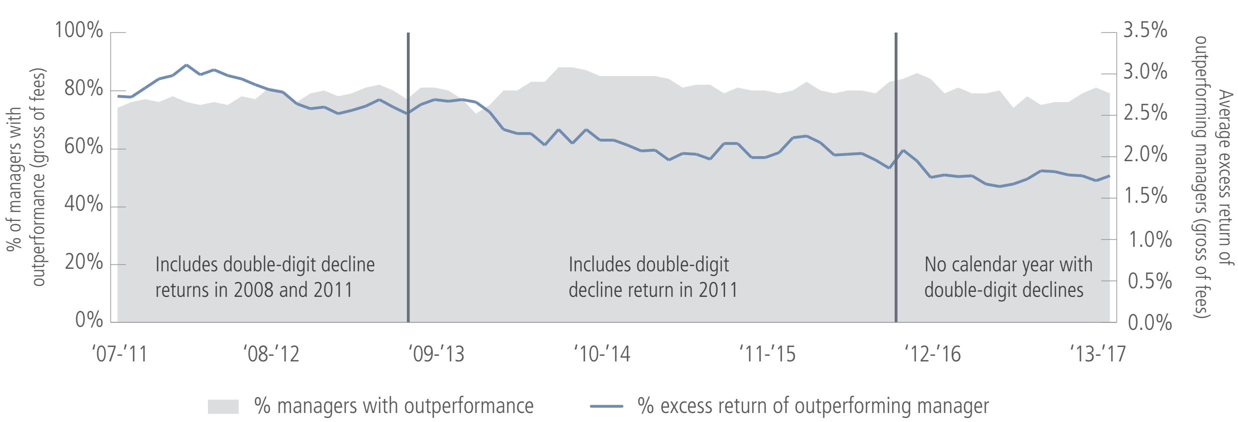
Relative Performance Favors an Active Approach

Despite the aforementioned fund flow data that would seem to suggest the contrary, active international equity managers have outperformed the benchmark handily over the past three years; the return of the MSCI EAFE Index—the most widely used benchmark for international equity strategies—placed in the 77th percentile compared to the broad eVestment EAFE Large Cap Core universe over this period. In fact, our analysis of active strategies in the eVestment EAFE Large Cap and EAFE All Cap universes benchmarked against the MSCI EAFE Index found that a significant majority outperformed the benchmark over all time periods going back over the last decade (2008 – 17), a time span that includes a few full market cycles.

As Figure 1 illustrates, a consistent 70 – 80% of active managers included in the aforementioned analysis have outperformed the index, on a gross of fee basis, over rolling five-year periods ended between 2011 and 2017. While the magnitude of average outperformance has fallen gradually from around 300 bps over the five-year periods ended earlier this decade—which captures such volatile times as the 2008 financial crisis and the 2011 Euro crisis—to its current 175 bps, it appears to have bottomed. We think the relative success of active management in non-U.S. equity markets could rebound in the near term as higher market volatility and lower stock return correlations provide international stock pickers increased opportunities to generate alpha.

FIGURE 1: ACTIVE MANAGERS HAVE CONSISTENTLY OUTPERFORMED THE BENCHMARK POST-CRISIS

Rolling Five-Year Relative Performance of Active EAFE Managers versus MSCI EAFE Index, 2007 – 17



Source: eVestment, data as of December 31, 2017.

Our analysis of the historical performance data showed that active strategies produced a downside capture ratio of less than 100—meaning that active managers typically lost less than their benchmark in down markets—in 72% of the five-year rolling periods during the measurement period. More revealingly, the magnitude of average active outperformance was greater in those five-year periods that captured both incidents of double-digit annual declines in the benchmark (2008 and 2011), pointing to a key differentiator that we believe helps effective active managers outperform their benchmarks in challenging markets: risk management. Of those strategies that delivered excess returns in our analysis, 81% of the time they did so while achieving a sub-100 downside capture ratio. These statistics not only suggest a relationship between the number and severity of down markets and the ability of active managers to deliver alpha, but also the vital role risk management plays in generating outperformance.

Benchmark Limitations = Active Opportunities

There are inherent limitations to passive investment portfolios attributable to the method by which equity market indexes—and thus the passive strategies that track them—are constructed. The default international index, in particular, has a number of shortcomings that investors may not be aware of.

As mentioned earlier, we have found that passive international equity strategies typically track the MSCI EAFE Index. This index is broadly diversified, with 928 large- and mid-cap stocks across 21 developed market countries. This may seem like a lot, but by omitting small-capitalization companies—generally, those with market capitalizations between $450 million and $2.5 billion—the index captures only about half of the 3,700-stock non-U.S. developed market investable opportunity set. A well-diversified investor—active or passive—likely wouldn't limit their U.S. equity exposure to only mid- and large-cap stocks; why should they in their international equity portfolios?

Another composition issue is that passive international equity investors benchmarked to MSCI EAFE are missing out on exposure to Canada, the sixth largest developed market outside the U.S. and an additional potential source of opportunities across the market-cap spectrum. When MSCI EAFE was developed in the 1970s, Canada was omitted given its perceived similarities with the U.S. market. These similarities no longer exist; in fact, the last 15 years of weekly price movements show that the correlation between S&P 500 and TSX Composite (the headline index for the Canadian equity market) is less than that of S&P 500 and MSCI EAFE. Active managers, in contrast, can have the flexibility to invest in non-benchmark securities as appropriate—including not only smaller-cap and Canadian stocks, but also in emerging markets.

Like many prominent indexes, MSCI EAFE weights its constituent countries, sectors and stocks according to their market capitalizations; this can result in outsized allocations to overvalued stocks and markets for passive portfolios that track these indexes, along with the outsized risk this concentration implies. In the late 1980s, for example, a passive portfolio benchmarked to MSCI EAFE would have had close to 60% of its assets invested in Japanese equities, just before the country's stock and real estate bubbles started to pop; by the end of 2017 Japan represented only 24% of the index. In contrast, the index's current weighting in information technology stands at 6%, which may not be consistent with the opportunities available in this sector given its much larger exposures in MSCI Emerging Markets (27%) and S&P 500 (24%) indexes. In addition, when examining sector constituents we found some sectors have country concentrations that are not truly representative of the wider universe; for example, while 62% of the MSCI EAFE technology sector is Japanese, Japan represents only 48% of the technology names in the broader non-U.S. developed market opportunity set. While passive investors are beholden to the weightings of their benchmarks, active managers can choose to overweight or underweight countries and sectors based on an assessment of their return potential.

Some investors may assume that index providers apply some sort of quality criteria to the stocks under consideration for inclusion in order to ensure that only businesses of a certain caliber are eligible. In fact, some indexes do maintain certain requirements for admission; for a stock to be added to the S&P 500, for example, it first must demonstrate "financial viability" in that the sum of its most recent four consecutive quarters of GAAP earnings as well as its most recent quarter is positive. However, MSCI indices, including MSCI EAFE, do not have such a financial viability requirement, suggesting that both money earners and money losers can gain entry.

Company Profitability May Lead to Stock Outperformance

We believe a company's financial viability is an important contributor to the performance of its stock. As such, we analyzed the earnings of the companies in MSCI EAFE as of the end of 2012, using return on equity (ROE)—rather than return on invested capital or any other metric—as a proxy for profitability given its greater availability. We segregated end-2012 index constituents into three profitability buckets: 7% (by weight) had negative ROE; 28% had ROE less than 8%, a rough estimate for the global cost of equity in a low interest rate world; and 61% generated a "profitable" ROE above 8%. We then tracked their performance from 2013 forward, using the subsequent five-year period (through year-end 2017) to capture a market cycle. (Note that ROE data as of December 2012 were unavailable for 4% of MSCI EAFE.)

As you can see on the left side of Figure 2, the aggregate total returns of stocks within those three buckets were markedly different over the five years that followed (2013 – 17). To see if this return disparity held true going back over time, we examined six rolling five-year periods, starting with 2008 –12 and ending 2013 – 17. On the right side of Figure 2, you can see that profitable companies outperformed the index and the other two cohorts by an even larger margin than in the first measurement. This demonstrates that profitable companies have yielded higher returns over time than those that were not profitable.

FIGURE 2: PROFITABLE COMPANIES HAVE DELIVERED BETTER RETURNS

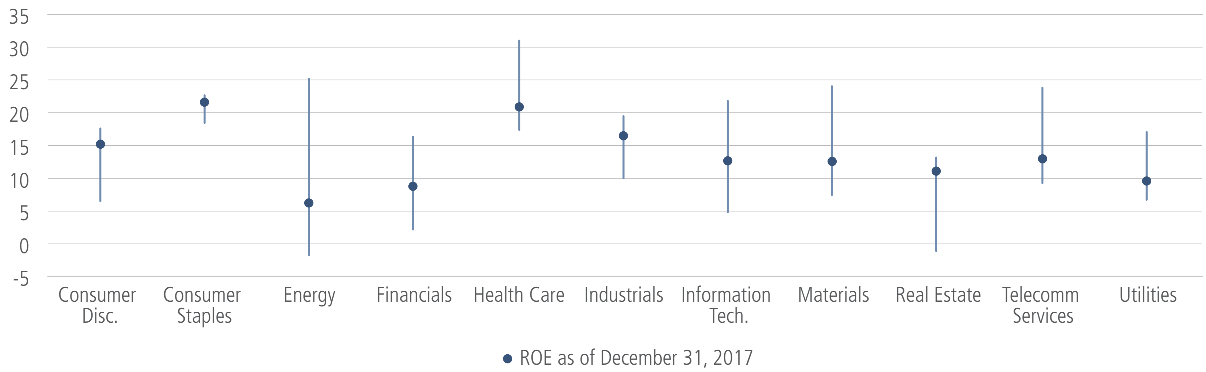
	Index Weighting as of December 2012	Total Return 2013 – 2017	Average Index Weighting over five-year rolling periods ended 2012 – 2017	Average five-year total return, rolling periods ended 2012 – 2017
MSCI EAFE Index	100%	46%	100%	33%
ROE > 8%	61%	61%	58%	57%
0% < ROE < 8%	28%	29%	29%	7%
ROE < 0%	7%	-12%	10%	-32%

Source: FactSet, data as of December 31, 2017.
Note: ROE data as of December 2012 were unavailable for 4% of MSCI EAFE. On average 2% of ROE data was unavailable across the five-year rolling periods ended 2012 – 2017.

Despite the above demonstration about the stock performance of profitable companies, there are two reasons why an international equity portfolio composed only of high-profit names could add risk and undermine returns: First, only a handful of market sectors and countries—like consumer staples and health care (see Figure 3) and the Netherlands and the U.K. (Figure 4)—have tended to generate outsized profits consistently. Not only could an emphasis on stocks in a limited number of sectors and countries expose a portfolio to concentration risk, it may also expose them unwittingly to the non-fundamental and temporal factors driving markets (such as a strong preference for growth). Second, cyclical sectors that do not consistently generate high ROEs—such as energy and materials—have tended to demonstrate their highest profits near the peak of the business cycle, just before their fundamentals and investment returns have taken a turn for the worse. A portfolio heavily weighted in companies at "peak earnings" may not be a recipe for attractive risk-adjusted returns going forward.

FIGURE 3: THE MOST PROFITABLE COMPANIES ARE CONCENTRATED IN CERTAIN SECTORS…

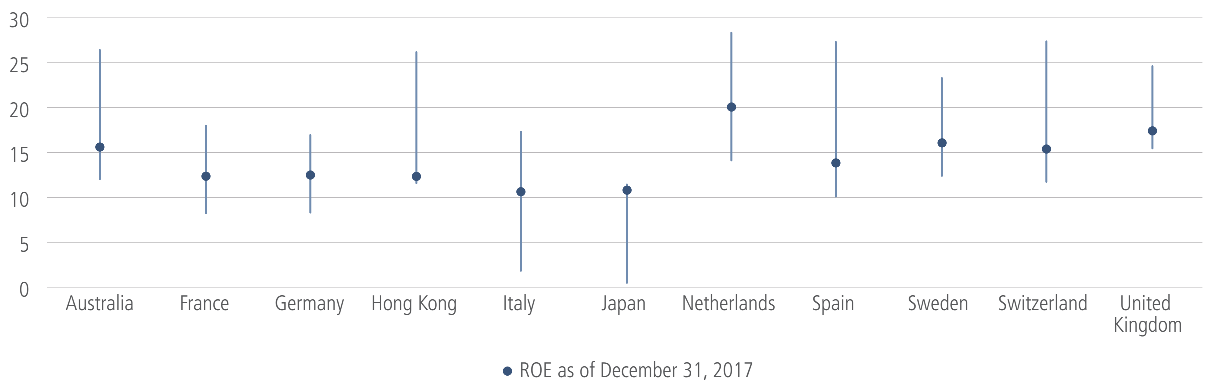
MSCI EAFE Index Quarterly ROE by Sector, 2007 – 2017



Source: FactSet, data as of December 31, 2017.

FIGURE 4: …AND IN CERTAIN COUNTRIES

MSCI EAFE Index Quarterly ROE by Country, 2007 – 2017



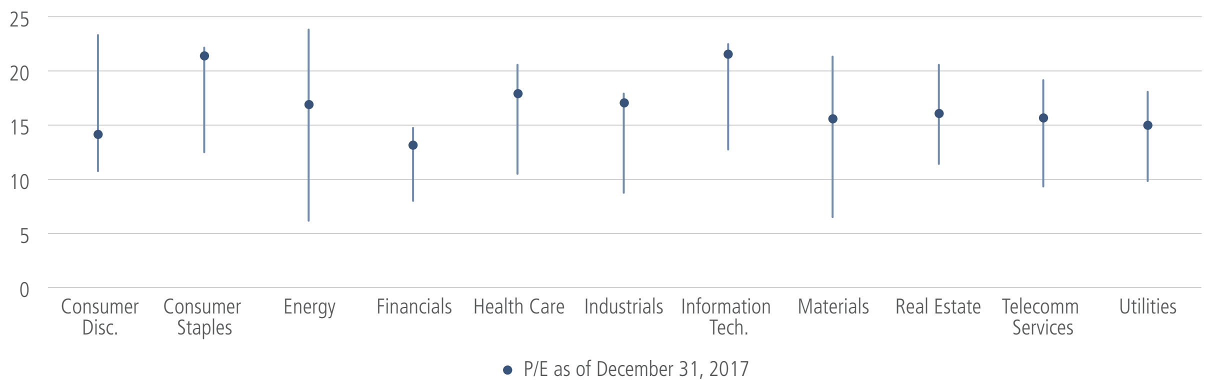
Source: FactSet, data as of December 31, 2017. Note: Includes only those countries with index weights in excess of 2%.

Valuations Follow Profits

While profitability impacts stock returns over the long term, valuation is a key metric in determining the attractiveness of an investment at any point in time. Stock valuations—as measured by price-to-earnings ratios, for example—can vary considerably by sector and country, as depicted in Figures 5 and 6 below. Note that consistently higher-profitability sectors like consumer staples and health care have tended to have higher P/E ratios, as have the higher-profitability countries like the Netherlands and the U.K. In contrast, a search for stocks with low valuations may lead investors to lower-profitability sectors like financials, countries like Italy, or sectors and countries whose profit levels fluctuate widely. Of course, valuation alone is not an indicator of potential return; it is but one input among many in the stock analysis process.

FIGURE 5: THE MOST PROFITABLE SECTORS TENDED TO HAVE THE HIGHEST MARKET VALUATIONS…

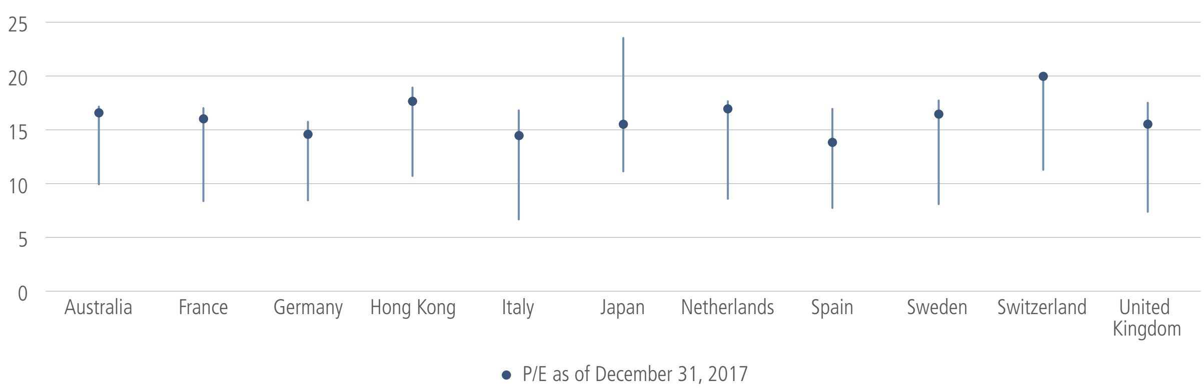
MSCI EAFE Index Quarterly P/E by Sector, 2007 – 2017



Source: FactSet, data as of December 31, 2017. Note: Negative values were excluded from the calculation of aggregate P/E.

FIGURE 6: …AS DO THE MOST PROFITABLE COUNTRIES

MSCI EAFE Index Quarterly P/E by Country, 2011 – 2017



Source: FactSet, data as of December 31, 2017. Note: Negative values were excluded from the calculation of aggregate P/E. Includes only those countries with index weights in excess of 2%.

An Active Management Toolkit

The aforementioned limitations inherent in benchmark construction can provide flexible active managers opportunities to generate alpha, but these may be confined to a few areas. As shown in our analysis of company ROE and valuations, active managers can possess a more powerful set of levers in their ability to look across 11 sectors, 21 countries and 3,700 stocks (and this is without including Canada and the emerging markets) to identify exploitable mismatches between a stock's valuation and its potential profitability; to look for stocks whose profit potential is not reflected in their low valuations, as well as stocks whose rich valuations fail to capture their prospects for diminishing profits.

Given the sheer number of possibilities, we believe a disciplined and repeatable investment process within a rigorous risk management framework is key. An active manager who takes the time to understand the underlying drivers of stock price movements and builds diversified portfolios of well-positioned companies across countries and sectors with an eye on both risk and return should be able to deliver superior risk-adjusted returns on a sustainable basis.

Conclusion

Though investors have continued to direct assets into passive international equity strategies, we believe that by doing so they are overlooking both the potential return and—perhaps more important given the increasingly volatile conditions we expect going forward—the risk management benefits of actively managed portfolios. Our analysis shows that a clear majority of active non-U.S. equity portfolios have outperformed their passive competitors in the years since the financial crisis, which we believe is owed in large part to the risk management features built into active investment processes to mitigate the impact of down markets.

Popular indexes—including the MSCI EAFE to which many passive non-U.S. equity portfolios are benchmarked—include many companies that we think investors should want to avoid and exclude many they should want to own; the flexibility afforded active managers can enable them to do just that. Spotting potential weaknesses is a key element for most active investors, and the favorable downside capture statistics posted by outperforming managers over most long-term periods suggest to us that this is a responsibility they do not take lightly. While such analysis takes time and resources, we think investors will continue to find the results valuable, as it can enable them to retain the potential for above-benchmark returns while also spending their risk budgets more efficiently.

If the early 2018 market selloff and spike in volatility is any indication, markets may be entering into a new regime of greater price movements—perhaps both downward and upward—as strong underlying corporate profitability and broadly positive economic indicators compete against a backdrop of marginally higher interest rates. This may point to a period during which thoughtful stock selection and limited downside capture become even more important to the total returns of international equity portfolios, which is why we believe active management can continue to outperform going forward.

NEUBERGER | BERMAN

Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

www.nb.com