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Non-US Stocks: the Opportunity and the Risks

RiverFront has increased exposure to non-US stocks in all of our portfolios over the last six months. We think their potential gains outweigh the risk, and we expect them to recover some of the underperformance of the last three years.

Country	Weight	Price to Book Value	Dividend Yield
United Kingdom	15.5%	1.8	3.1
Japan	13.3%	1.0	2.3
Canada	7.8%	1.9	2.6
Australia	6.4%	2.0	4.1
France	6.4%	1.3	3.4
Germany	6.3%	1.6	2.7
Switzerland	6.1%	2.5	2.9
South Korea	3.3%	1.6	1.3
Brazil	3.0%	1.6	4.1
China	2.9%	2.0	2.2
Sum of top 10:	*70.8%*		
World Ex-US (Total)		**1.6**	**3.0**
US		**2.3**	**1.8**

Source: RiverFront, JP Morgan Quant, FactSet Research Systems

	MSCI All Coutry World Ex-US	S&P 500
Energy	9.4%	11.2%
Materials	11.2%	3.5%
Industrials	10.3%	10.3%
Discretionary	11.6%	11.1%
Technology	5.0%	18.4%
Financials	25.8%	16.0%
Staples	9.8%	11.1%
Healthcare	7.7%	12.3%
Utilities	3.9%	3.4%
Telecom	5.4%	2.9%

Source: RiverFront, FactSet Research Systems

All data as of 2/15/13. Dividends are not guaranteed and are subject to change or elimination.

The size of a country's economy often bears little relation to the success of its companies or its weighting in global indexes. The countries that posed the greatest risk to global markets, primarily in peripheral Europe, are a small part of both RiverFront's portfolios and the MSCI World ex-US Index.

The size of a country's economy often bears little relation to the success of its companies or its weighting in global indexes. The ten largest countries in the MSCI All Country World ex-US Index make up 70% of the index, weighted by the stock market capitalization of each country (see top left table). Note the high position of two relatively small economies – Canada and Australia – and that the UK's weighting is bigger than France and Germany combined. Further down the list (not shown) Hong Kong and Singapore together make up 3.5%, about the same as Italy and Spain combined. These countries achieved their weighting in this index predominantly through the success of their companies' global businesses. Our point is that the countries that posed the greatest risk to global markets, primarily in peripheral Europe, are a small part of both RiverFront's portfolios and the MSCI All Country World ex-US Index.

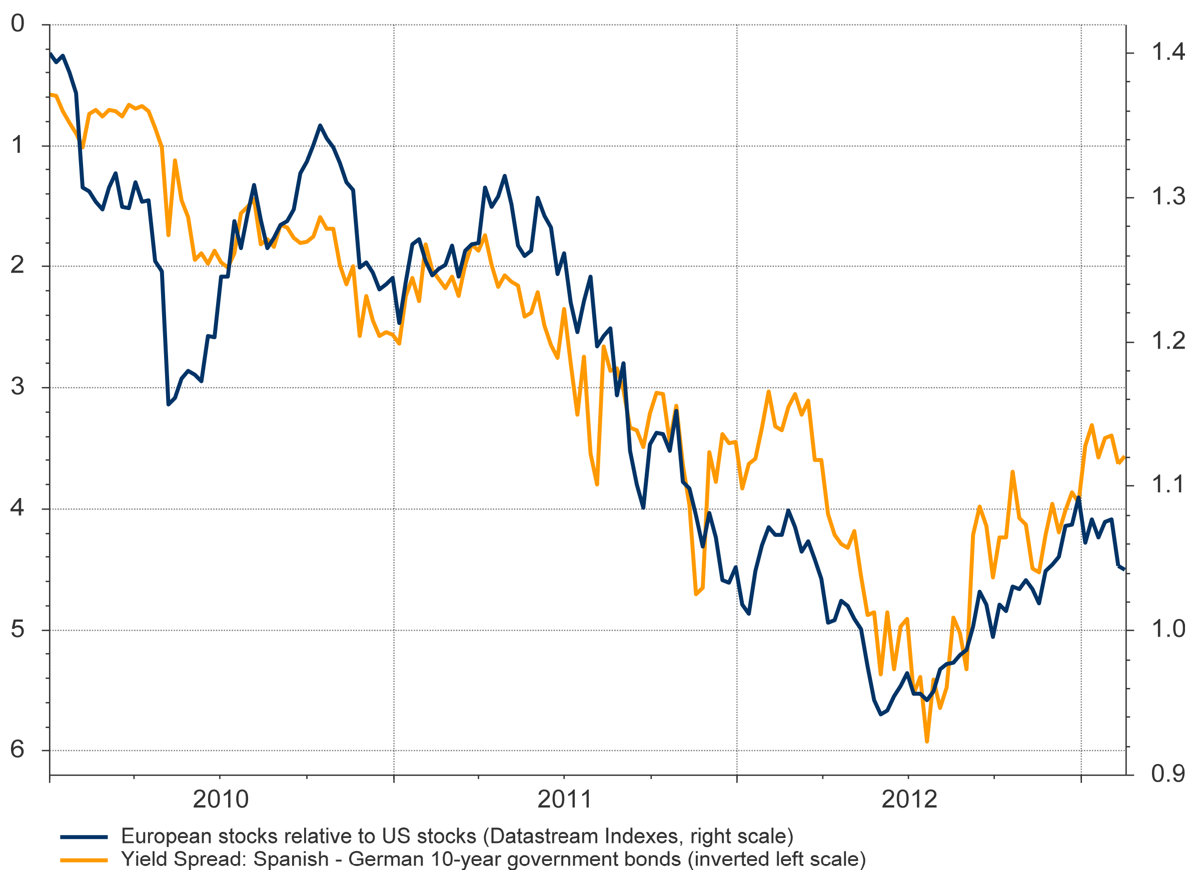
Non-US markets have underperformed for good reasons: Europe and Japan continue to flirt with recession and, until last year, policymakers have been more focused on deficit-reducing austerity measures rather than pro-growth reforms. Earnings and margins are average at best, whereas S&P 500 margins are close to record highs and reported earnings are 12% above trend. This presents a risk for the US and an opportunity for the rest, in our view. Most importantly, fears of a sovereign debt crisis and a Euro break up – which appeared imminent during the mid-2010 to mid-2012 crisis – have receded as austerity measures have started to shrink budget deficits and the European Central Bank (ECB) has offered a backstop for sovereign debt. Since ECB President Mario Draghi's commitment to "do whatever it takes" last summer, we think the ability of peripheral Europe to derail the world economy has been diminished.

The sector composition of the MSCI World ex-US Index helps explain lower non-US stock valuations (top left table) and their greater opportunity for earnings and margin growth to benefit from a cyclical recovery. Non-US stock indexes have significantly greater exposure to materials

and financials, offset by less exposure to technology and healthcare, (see top right table, page one). The primary risk to our thesis is that the growth does not materialize. Furthermore, non-US companies and their domestic shareholders prefer dividends to share buybacks, so the dividend yield is almost twice that of the US.

With the ECB committed to using its balance sheet to prevent a sovereign debt crisis and Japan determined to end two decades of deflation, we find the relative valuation of non-US stocks appealing. However as regular readers know, we like to see sign of relative price stability and then outperformance to feel confident in higher weightings. Non-US markets outperformed in the last half of 2012 by enough for us to conclude that their three-year period of underperformance is ending. We are hopeful that they will now climb the same 'wall of worry' that US stocks have been climbing for four years (see *The Weekly View*, 2/11/2013), driven by low interest rates, falling sovereign credit spreads, and accelerating global growth.

THE WEEKLY CHART: SPANISH BOND SPREADS REFLECT DIMINISHED EUROZONE RISKS



Source: Thomson Reuters Datastream

Past performance is no guarantee of future results.

Economies and markets that are relatively small have had a significant impact on global performance in the last three years. From 2010 to 2012, the PIIGS – Portugal, Italy, Ireland, Greece and Spain – have dominated global leadership summits, newspaper headlines, and market commentaries. Indeed, our chart shows a 90% inverse correlation between Europe's relative performance to the US (dark line) and the spread of Spanish bond yields over German yields (a clear measure of Spanish sovereign default risk). At the mid-2012 peak of the crisis, Spanish bond yields were 6 percentage points higher than German ones (left hand scale is inverted). The spread has since tightened to 3.5.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market. MSCI ACWI ex US Index captures large and mid cap representation across 23 of 24 developed markets countries (excluding the United States) and 21 emerging markets countries. The index targets coverage of approximately 85% of the global equity opportunity set outside the US. It is not possible to invest directly in an index. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.