

Prospects across global markets



PETER RATHJENS
 Managing partner
 and chief investment
 officer at Arrowstreet
 Capital.

A long-term view: U.S. versus EAFE.

While the decision to diversify internationally in the last 10 years has benefited Canadian investors, almost all of that benefit has derived from investments in the United States, rather than in Europe, Australia and the Far East (EAFE).

A close examination of the performance differential between U.S. and EAFE equities, however, reveals three notable results.

First, some of the performance differential results from the relative strength of the U.S. dollar. On a hedged basis, the difference, while still substantial, is smaller. Second, some of the performance differential results from the unusually poor performance of Japanese equities, a substantial component of EAFE. On an EAFE-excluding-Japan basis the differential, while still meaningful, is smaller. Finally, much of the remaining differential is concentrated in the period from 1994 to 1998, corresponding to the technology bubble. Note, however, that a substantial performance differential, even on a hedged basis, existed for more than a decade. Should Canadian investors expect this trend to continue going forward?

The outperformance of U.S. equities relative to EAFE equities in the 1990s should not be interpreted as suggesting that the same trend will continue in the future. In fact, there is no evidence that the U.S. is in any way systematically riskier than other securities. Therefore, it should not merit a risk premium. Moreover, the longer-term evidence suggests that the last 10 years' outperformance is not typically the rule; the U.S. was one of the world's poorer performers over the previous 20 years.

This is not to suggest, however, that investors should presume equal expected returns across all countries notwithstanding recent, or even longer-term history. A simple model is constructed which demonstrates that the performance of country stock markets

can be systematically related to three signals: mid-term (one-year) momentum, long-term (10-year) momentum, and dividend yield. Specifically, countries with relatively attractive one-year momentum tend to outperform countries with relatively unattractive one-year momentum, countries with relatively attractive 10-year momentum tend to underperform countries with relatively unattractive 10-year momentum, and countries with relatively positive dividend yield tend to outperform countries with relatively negative dividend yield. While this model leaves much of the variation across equity markets unexplained, it does provide a method for forming long-term expectations that is demonstrably superior to assuming the same expected returns across all countries.

Given current conditions, the long-term forecasts are most positive for some of the smaller Pacific Rim countries, including, most notably, New Zealand and Hong Kong. These are countries or markets that have positive mid-term momentum, yet also have negative

THE OUTPERFORMANCE OF U.S. EQUITIES RELATIVE TO EAFE EQUITIES IN THE 1990S SHOULD NOT BE INTERPRETED AS SUGGESTING THAT THE SAME TREND WILL CONTINUE IN THE FUTURE.

long-term momentum and high dividend yields, making them attractive on every basis. The U.K. and Belgium, which also have relatively poor long-term momentum and high dividend yields, are the most attractive countries in Europe. Finland and Switzerland have the least attractive long-term forecasts on the basis of their recent success and low dividend yields. Note also that the U.S. is the fifth least-attractive country out of a universe of 23 developed markets, ahead of only Finland, Switzerland, Japan, and Sweden. Finally, Canada ranks as the sixth least attractive country. ■