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the rumors of the death of non-US investing have been greatly exaggerated.

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Cycles are inevitable in the financial world and their existence creates a significant challenge for investors; how does one muster the courage to maintain what was thought to be a sensible investment program when things are going badly?

In particular, it is very difficult to stay the course when one component of a portfolio is performing poorly. In the midst of one of these inevitable events, the natural tendency is to believe that the investment in question has experienced a permanent change in outlook that dictates a reallocation of funds to what are perceived to be more promising alternatives. (Typically those that are performing well.) More often than not, the reality is that the underperformer is simply out of favor and will likely enjoy a rebound in the near future. Of course, the fact that the underperformance is temporary is only clear in hindsight, so most people have difficulty fighting the urge to "fix" their portfolio by eliminating the problem child. Unfortunately, the "fix" generally occurs at the worst possible time because the cycle typically reverses and the "underperforming" asset turns out to be the big winner in subsequent periods.

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We are experiencing one of these painful episodes right now as Non-US Stocks have declined by 14% over the past year as compared to a positive 5.5% return on large capitalization US Equities. In part because of this poor year, the five year annualized return on Non-US Equities is now negative 4.2% as compared to a positive return of .2% on blue chip US Stocks. The cumulative impact of such a significant spread over a five year period is quite significant as a portfolio of Non-US Stocks would be worth only 80% of its US Equity counterpart. When combined with the outstanding performance of US Treasuries versus other types of bonds, these results suggest that more diversified portfolios have significantly underperformed a simple structure consisting of US Stocks and Treasury Bonds. As if the numbers themselves were not bad enough, we are also barraged with daily headlines regarding the dire state of finances in Europe and fears of a slowdown in the growth rate in China and other emerging economies. In the face of all of this, some investors have chosen to throw in the towel on diversified portfolios in general, and international investing in particular.

In contrast, we believe there are compelling reasons to maintain globally diversified portfolios although some of the benefits are hard to quantify precisely. Several of them are structural in nature whereas others are more cyclical. Let's begin with the longer term focus.

structural benefits of globally diversified portfolios.

One of the basic principles of finance is that combining different assets that do not move in tandem will result in a more stable, less volatile portfolio. And, without boring you with the math, the future value of a stable portfolio will exceed that of a volatile one with the same average return. So there is a financial benefit to relative stability in addition to the value of a good night's sleep. The extent to which different assets move in tandem is measured by a statistic known as the correlation coefficient which ranges between -1 and +1. A coefficient of -1 suggests that two investments move in exactly the opposite direction whereas a value of +1 means they move together. In the case of US and Non-US stocks, the coefficient has been approximately .8 which means that they tend to move in the same direction, albeit not in perfect lockstep. But, this lack of perfect correlation is enough to provide a modest diversification benefit. In other words, including an international stock allocation should dampen the

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swings in an overall equity portfolio. For example, over the past fifteen years, a 20% allocation to International Equities would have increased the annual return on an equity portfolio by .5% with slightly less volatility. Part of this benefit results from the fact that foreign stocks are denominated in other currencies. Should the Dollar decline in value versus other currencies as some forecast, an allocation to non-US assets should also help preserve portfolio value.

Most investors believe that stock returns are heavily influenced by the rate of growth in corporate earnings which are in turn importantly influenced by overall economic growth. There are a number of other variables involved, the most important of which is valuation, so it is not as simple as suggesting that higher economic growth leads to better stock returns. But, robust economies do create an environment in which some companies can prosper which should create opportunities for good stock pickers. For a number of years, the economies of the emerging markets have been growing at more than double the rate of the mature industrialized world. As one would hope, Emerging Market stocks have generated an annual return of 6.3% over the past fifteen years as compared to 4.8% for large capitalization US stocks. While there are legitimate fears that their growth may be slowing somewhat, the emerging markets are still expected to grow by approximately 6% in 2012 as compared to about 2% for the industrialized economies. Once again, this does not guarantee superior stock performance, but it does create an environment for companies operating in higher growth economies in which the "wind is at their back." As an aside, large multinational US and European companies are also beneficiaries because they derive significant revenues from emerging countries.

The most compelling structural reason for investing outside the US is that there are many wonderful companies domiciled in the rest of the world. Many of these companies are dominant global players. But, by limiting a portfolio to US domiciled companies, these opportunities are off the table. Just to name a few, Anheuser Busch Inbev, SAP, Unilever, Nestle, GlaxoSmithkline, Royal Dutch Shell, Rolls Royce, and Philip Morris International are all large non-US companies that should certainly be available to a skilled stock picker for potential inclusion in a portfolio. In fact, slightly more than one half of the world's stock market is located outside of the US which suggests that those who have thrown in the towel on international investing are excluding more than half of the universe of available investments.

cycles.

As mentioned at the outset, cycles are inevitable in the financial markets, and they are influenced by a very powerful force known as "regression to the mean." When one investment category veers significantly from its historical relationship to other categories, savvy investors will intervene by buying the cheaper asset and selling the more expensive one. This activity has the effect of moving the relationship back toward normal; in other words, regressing to the mean.

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From 1992 to 2002, large capitalization US Stocks provided an annual return of 9.2% versus only 2.6% for an index of Non-US Equities. As a result of that huge spread in return, the US stock portfolio achieved twice the value of its Non-US counterpart over this period. Not surprisingly, value conscious investors perceived that international stocks were relatively cheap and pounced on the opportunity. Over the next five years, Non-US Stocks returned 26.6% annually versus 14.4% for the Standard and Poor's 500, which is a widely used index of US stocks. That strong period of relative returns by Non-US stocks offset most of the underperformance of the prior period. Beginning in late 2007, the trend reversed yet again with US stocks earning annual returns through today of -.5% versus -6.8% for Non-US Equities. If history is any guide, we are due for another reversal in the cycle in which Non-US stocks dominate. But, the length of cycles varies significantly over time and there needs to be a catalyst for investors to change their thoughts about the relative attraction of US versus international stocks.

valuation.

In the face of all of the bad news about Europe and the fears of a slowdown in the emerging markets, what will motivate investors to leave the perceived safety of US stocks for other markets? In other words, what will cause a reversal in the relative performance trend that has been in place for almost five years? The answer is relative valuation. At some point, the underperformance of Non-US stocks will make them so cheap as compared to US equities that investors will look past the headlines and make significant portfolio shifts. Of course, it is very difficult to determine how "cheap" is "cheap enough" or when investors will change their point of view. But, a number of the statistics are already compelling.

A simple measure of relative valuation is the dividend yield. Today, large capitalization US stocks provide a dividend return or yield of 2.3% which compares with 3.6% for the BRIC countries (Brazil, Russia, India, and China) and 4.4% for European stocks. So, while the economic outlook for Europe is highly uncertain, European stocks are providing almost twice the up-front cash return of their American counterparts. A second common measure of value is the price earnings ratio which is really an indicator of investor sentiment. Using forecast earnings for the next twelve months, the price earnings ratio for large capitalization US stocks is 12.7 versus 10 for European stocks and 9.9 for Emerging Market equities. In other words, non-US stocks are about 20% cheaper than their American counterparts. Some market observers are skeptical of this measure because analysts are frequently too optimistic regarding future corporate earnings which means that the price earnings ratio may be understated. So, another version compares price with average earnings over the past five or ten years. This is called the cyclically adjusted price earnings ratio and is designed to smooth out the short term effects of the business cycle. On that basis, US stocks are selling 16% above their long term average price earnings ratio whereas Emerging Market stocks are at a 28% discount and European stocks a 46% discount.

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The large gap between the valuation metrics of US and Non US equities has significant potential implications for returns. One of our investment managers, Grantham, Mayo, Van Otterloo, has been making monthly forecasts of prospective returns on various asset classes for almost twenty-five years. Without getting into all of the details, their track record is excellent although their timing is never perfect. In any case, their forecast of annualized returns for the next seven years is as follows:

- Large Capitalization US Stocks 3.0%
- Non-US Industrialized Country Stocks 8.3%
- Emerging Market Stocks 8.9%

We would not assign too much weight to the returns themselves, but agree with the basic message that Non-US equities represent attractive values at current levels.

stay the course.

Diversified Trust Company was founded on the principle that success in investing results from earning consistent returns while avoiding excessive volatility. The best way to achieve these goals is by maintaining diversified portfolios and resisting the urge to overreact to short term trends. We believe that an allocation to Non-US equities represents an important component of a long term, sensible investment strategy. And, while we will never get the timing just right, all of the data suggest that we are at a point where Non-US stocks offer particularly attractive returns. So, let's not "fix" portfolios that are not broken. ■

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